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THE NEW YORK

Certified Public Accountant

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Society and Editorial Offices: 677 Fifth Avenue, New York 22, N. Y.

Accounting News And Trends

Credit Grantors and Auditing and Reporting Standards

At one place in his article "A CPA's Observations On Use of Audits by Lenders" (BULLETIN OF ROBERT MORRIS ASSOCIATES, October 1958) Mr. George E. Perrin voices a criticism of the attitude of some banks toward audit reports. He points out that there have been cases in his experience where companies have refrained from having an audit made because the bank suggested it would not be necessary.

One such situation involved a manufacturing company in North Carolina which desired an initial audit because it needed to borrow money beyond its usual needs. In checking with an out-of-state bank about a CPA they proposed to engage, the company was informed that while the CPA was highly recommended, there was no real need for an audit because the bank was quite certain that increased credit could be granted without it. Of course, the company did not have the audit made when the bank thus suggested that an important safeguard to its own position should be cast aside.

Another instance concerned the inclusion of a footnote calling attention to a large contingent liability in the financial statements. The client objected vigorously to this footnote, but the CPA, in his desire to maintain sound professional standards, was insistent. His position was made considerably more difficult, however, when the client mentioned the matter to his bankers and was told that so far as the bank was concerned there was no need to include this footnote. In the end the CPA prevailed but his efforts to protect the bank's interest by disclosure of a vital matter did not seem to be understood by the credit grantor.

Financial Statements for Municipalities

The California Society of CPAs has published "Typical Financial Statements for California Cities" as the third in its series of booklets prepared by its Committee on Municipal Accounting in furtherance of its endeavor to "more adequately serve the public interest and to provide the highest degree of sound fiscal administration."

The statements in this pamphlet were developed to present the recommended form for annual financial statements. They have been prepared in conformity with generally accepted principles of municipal fund accounting, and include examples of fund classifications which are typical to California cities. The statements are based upon the recommendations of the National Committee on Governmental Accounting as contained in their Publication No. 14 entitled "Municipal Accounting and Auditing" modified to illustrate statement presentation of problems normally encountered by California cities. The terminology used in the statements has been coordinated with the account titles recommended in the previous publica-

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ACCOUNTING NEWS AND TRENDS *is conducted by* CHARLES L. SAVAGE, CPA *and member of the New York Bar. He is presently serving as a member of our Society's Committee on Legislation.*

Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College.

VERSATILITY AND ECONOMY of operation are keynotes to an accounting department equipped with a National System.

DAVID KNOPPING, Treasurer of Super Market Distributors, Inc.

THREE NATIONAL ACCOUNTING MACHINES, like this one, speed our customer's billing because extensions and computations are performed with mechanized accuracy.

tion "Chart of Accounts for California Cities."

A greater uniformity in municipal financial reporting is desirable to foster more comparable municipal reports for analytical purposes and a better understanding of such reports. Since the general adoption of these recommended forms of municipal financial statements can materially further this purpose, this publication of the Committee can help to achieve these worthwhile objectives.

Statement Studies

This department is again happy to call the profession's attention to the latest STATEMENT STUDIES prepared by the Robert Morris Associates (The National Association of Bank Loan Officers and Credit Men). The 1957 edition covers 165 lines of business, nine more than formerly. The statistics were gathered by 500 banks and are drawn from nearly 12,000 individual

statements of firms engaged in manufacturing, wholesale and retail trade.

These studies are common-size composite financial statements expressed in percentages and showing appropriate ratios. They can be extremely helpful to CPAs in analyzing a client's performance in comparison with over-all averages for his line of business. The price of the study is $10 but tear sheets for particular industries are also available for one dollar each.

Auditing Standards and the Audit of Municipalities

The third and final educational bulletin on "Auditing Standards and the Audit of Kansas Municipalities" was published in the Kansas Society's NEWSLETTER of September 24, 1958. Bulletins Nos. 1 and 2 were discussed in this Department in August and November 1958, respectively.

This bulletin consists of check lists which may be inserted beside the accountant's work program. These lists have been prepared to make available to the CPA the common infractions noted by the Kansas Department of Post Audits. Because of the specific information contained therein that might be of great help to accountants engaged in municipal audits, extensive quotations are made from these lists, as follows:

COMMENT DEFICIENCIES

1. Failure to cite statutory violations.

2. Failure to disclose required funds not budgeted.

3. Failure to challenge legality and propriety of expenditures.

4. Failure to cite illegal diversion of funds (temporary borrowing).

5. Failure to report upon inadequate internal control.

6. Failure to cite illegal petty cash funds.

7. Failure to report illegal lease-rental contracts.

8. Failure to report diversion or misuse of bond proceeds.

9. Failure to disclose unauthorized investments.

PROCEDURE DEFICIENCIES

1. Failure to use current statutory citations.

2. Failure to state proper source of state confirmations.

3. Failure to examine or name boards or agencies not examined.

4. Failure to correct improper distributions made by county treasurer (ad valorem tax, residue sales tax, cigarette stamp tax, liquor control enforcement tax).

STATEMENT DEFICIENCIES

1. Failure to reconcile accountable balances with available cash and investments.

2. Failure to identify reimbursed expenditure credit.

3. Failure to reflect comparison by item, by fund, when required.

4. Failure to disclose disposition made of amounts due from officials in subsequent audit reports.

5. Failure to present activity of nonbudgeted funds.

6. Failure to present required statements in the statistical section of the audit report.

7. Failure to show order number of no-fund warrant authorization.

8. Failure to include all encumbrances within *expenditures*.

9. Failure to compare unencumbered cash balance with anticipated amount where required.

10. Failure to compare statutory salaries with amounts paid where required.

11. Failure to reconcile fiscal agency balances.

Letters to the Editor

The Federal Wage and Hour Law

An Audit Check List for Accountants

In complying with Federal regulatory legislation, more and more businessmen are turning to the accounting profession for advice. The accountant, on his part, is finding it increasingly necessary to keep himself well-versed in all laws affecting industry's day-to-day operation. One of the most important of these is the Fair Labor Standards Act, administered by the U. S. Department of Labor's Wage and Hour and Public Contracts Divisions.

Typically, an accountant will be introduced to his client's Fair Labor Standards Act problems through his concern with the firm's records. The Divisions' regulations, Part 516, require that an employer record certain information on wages, hours and other data of the kind generally maintained by prudent businessmen. In the course of consultation, the accountant frequently finds the discussion will turn to the application of the Act's minimum wage, overtime pay and other requirements. Such matters not only can have important bearing on the financial structure and disbursements of the client firm, but have a major position in the framework of modern economic legislation, along with unemployment benefit, workmen's compensation, old age and survivors' insurance and other social security measures provided by Federal, State or local laws.

Thus, the accountant, though not desiring to set himself up as an expert on the Act, finds it good business policy to have general familiarity with the law and to know what publications the Divisions have issued on various statutory requirements. Interpretations of the Statute should be a matter for the client's attorney. Of course, the accountant may refer his client to the Divisions' nearest office, or consult with the Divisions himself.

Given the fact that the Act—which is popularly known as the Federal Wage and Hour Law—applies to some 24 million workers employed by about 900,000 firms throughout the United States, it is easy to see how important the accuracy of the accountant's information can be to both employers and employees. The vast majority of employers want to comply, and proper advice can help a firm avoid those inadvertent violations that can result in unexpected cash outlays for back wages.

The Fair Labor Standards Act (Federal Wage and Hour Law) requires payment of a minimum wage of $1.00 an hour and at least time and one-half the employee's regular rate for all hours worked over 40 in a workweek. It also restricts child labor. Its provisions apply to employees engaged in interstate commerce or in the production of goods for interstate commerce, unless specifically exempt. The Act is administered by the U. S. Department of Labor's Wage and Hour and Public Contracts Divisions.

The accompanying audit check list for accountants may be helpful in reviewing a client's operations under the Federal Wage and Hour Law for a two-year period. If your readers can reply in the affirmative to the questions listed, it means their clients have avoided some pitfalls which are among the most common causes of violations of this law.

In reprinting this check list in your authoritative publication, THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT, you can contribute greatly toward helping us carry out the objectives of Secretary of Labor James P. Mitchell to

secure compliance through information and education. Our limited investigation staff may then devote its efforts to the deliberately negligent and wilful violators.

Audit Check List for Accountants in Reviewing Client's Operations under the Federal Wage and Hour Law for Two-Year Period

ON RECORDS:

1. Do the records accurately reflect all hours worked?

   Note: Spot check the basic time records against the payroll to insure accurate time entries.

2. Do the records contain the following items required by the Divisions' regulations, Part 516, on Records?

   (a) The employee's name, address, occupation and date of birth if under 19.

   (b) Basis on which wages are paid (i.e., \$1.00 an hour, \$60 a week, piece work, etc.).

   (c) Hour and day when workweek begins.

   (d) Daily hours and total weekly hours.

   (e) Daily or weekly straight-time earnings.

   (f) Regular hourly rate for any week when overtime is worked.

   (g) Total overtime pay for the week.

   (h) Deductions or additions to wages each pay period.

   (i) Total wages paid each pay period.

   (j) Date of payment and pay period covered.

   Note: The regular hourly rate of pay need not be shown separately if the Divisions' Form FO-135, "Coefficient Table for Computing Extra Half Time for Overtime," is used.

3. Does the employer keep payroll records for at least three years? Are supplementary records, such as time sheets and time cards, kept at least two years? Are the records accessible for examination by the Divisions' representatives, and is the employer ready to provide facilities for viewing any microfilm copies he may keep?

4. Do the records contain the proper data for exempt employees?

5. Are markedly increased earnings during peak operations consistent with recorded hours of work?

ON THE MINIMUM RATE:

6. Are all nonexempt employees paid at a rate of at least \$1.00 an hour?

   Note: Learners, student-learners, apprentices, and handicapped workers may be paid special minimum rates, pursuant to certificates issued by the Divisions. If there are such employees, make sure the certificates have not expired and that the workers are paid at least the rates speci-

fied in the certificates, and not less than time and one-half those rates for all hours worked over 40 a week.

On Overtime Pay:

7. Are all nonexempt employees being paid at least time and one-half their regular rates of pay for each hour worked over 40 a workweek?

Note: The law applies not only to production workers, but to clerical, maintenance, shipping and sales personnel, among others.

8. Does the employer include all compensation for employment in the regular rate?

Note: All remuneration for employment must be included, except certain specified payments enumerated in section 7(d) of the Act.

9. Are such payments as shift differentials, production bonuses, cost-of-living bonuses and commissions, included in the employee's regular rate for overtime pay purposes?

Note: Make certain that production bonus payments and salary increases are not construed by the employer to represent extra payment for overtime.

10. Does the employer compute properly the regular rate?

Note: The regular rate is a rate per hour obtained by dividing the total straight-time pay for the workweek (except any overtime premiums and other payments excluded by the law) by the number of hours worked for which it is paid. It may be more than the minimum, but not less. Time and one-half the minimum, therefore, does not satisfy the overtime pay requirements, unless the regular rate is actually no more than the minimum.

11. Does the employer compute overtime pay on the basis of each workweek standing alone?

Note: Make certain that the employer is not averaging overtime hours worked in one week against less than 40 hours worked in other weeks.

12. Are piece workers, as well as other employees, paid premium rates for overtime hours?

Note: Make certain piece workers are paid at least the minimum. Where a piece worker's regular rate falls below the minimum, he is due make-up pay.

On Exemptions:

13. Does the employer properly apply any exemptions he may claim?

Note: The law provides exemptions for employees in various industries and occupations. For the exemption provisions, see a copy of the Fair Labor Standards Act. Also refer to applicable interpretative bulletins and regulations issued by the Divisions. Suggest the employer consult with the firm's attorney or the Divisions, in all questionable cases.

14. Do all employees for whom the "white-collar" employee exemption is taken meet the exemption tests?

Note: One of the few exemptions which cut across industry lines is provided for executive, administrative and professional employees, outside salesmen, and local retailing employees—the so-called "white-collar" employee exemption. The exemption is inapplicable to the usual secretary, bookkeeper, or similar office worker. Check carefully the exemption tests contained in the Divisions' regulations, Part 541, and see also the explanatory bulletin on these regulations.

On Homeworkers:

15. If homeworkers are employed, are they paid in accordance with the minimum wage and overtime provisions, and are the child-labor provisions observed? Is a homeworker's handbook kept for each homeworker, as required by the Divisions' regulations, Part 516? In addition, is there a homeworker's certificate for any homeworker employed in a restricted industry?

Note: Employment of homeworkers is restricted to persons having homework certificates issued by the Divisions, in the following seven industries: Women's apparel, knitted outerwear, gloves and mittens, button and buckle manufacturing, handkerchief manufacturing, embroideries, and jewelry manufacturing.

On Child Labor:

16. Are young people employed in manufacturing or processing, or in rooms where goods are manufactured or processed, at least 16 years old? Are they at least 18, if working in hazardous jobs? If any 14- or 15-year-olds are employed, are they working outside school hours and under permissible conditions?

Note: The Act sets 16 years as the minimum age for most jobs, and 18 as the minimum for work in occupations designated hazardous by the Secretary of Labor. Children of 14 and 15 may work outside school hours in a few jobs, such as office and sales work, under strict regulations on hours.

The Walsh-Healey Public Contracts Act:

17. In cases where the employer is performing on a Government contract under the Walsh-Healey Act, are employees paid at least the prevailing minimum wage for the industry, as determined by the Secretary of Labor? Are they paid at least time and one-half the basic rate (which is the same as the regular rate under the Fair Labor Standards

Act) for all hours over 8 a day or 40 a week, whichever is the greater number of overtime hours? Does the employer see to it that no boy under 16 or girl under 18 works on the contract?

Note: The Walsh-Healey Act, also administered by the Divisions, is a law which sets basic labor standards for employees working on Government supply contracts in excess of $10,000. It contains minimum wage, overtime pay, child labor and safety and health provisions. It protects employees who produce, assemble, handle or ship goods required by the contract, but does not apply to executive, administrative and professional employees, or to office workers, and certain custodial workers. Homeworkers may not be employed in the performance of contracts subject to this Act.

Employees whose work is subject to the Walsh-Healey Act are usually covered by the Fair Labor Standards Act, also. In such cases, the provisions of both laws must be observed, and to the extent that the statutory requirements differ, there must be compliance with the higher.

The following are some of the Divisions' free publications which you may find helpful:

Regulations, Part 516, on Records
  Subpart A, General Requirements
  Subpart B, Miscellaneous Exemptions
Regulations, Part 522, on Learners
Regulations, Part 520, on Student-Learners
Regulations, Part 521, on Apprentices
Regulations, Part 524, on Handicapped Workers
Interpretative Bulletin, Part 785, on Hours Worked
Interpretative Bulletin, Part 778, on Overtime Compensation
WHPC Form FO-135, Coefficient Table for Computing Extra Half Time for Overtime
Regulations, Part 548, on Authorized Basic Rates (and explanatory bulletin)
Regulations, Part 541, on Executive, Administrative, Professional, Outside Salesmen and Retailing Employee Exemptions (and explanatory bulletin)
Bulletin No. 101, Guide to Child-Labor Provisions of the Fair Labor Standards Act
Rulings and Interpretations No. 3 Under the Walsh-Healey Act
The Fair Labor Standards Act
The Walsh-Healey Public Contracts Act
List of Publications

The above publications, and answers to questions about the Fair Labor Standards Act or Walsh-Healey Public Contracts Act, may be obtained from the field offices of the U. S. Department of Labor's Wage and Hour and Public Contracts Divisions. The New York-New Jersey regional office is located at 341 Ninth Avenue, New York 1, N. Y.

Thank you sincerely for this public service.

CLARENCE T. LUNDQUIST, Administrator
Wage and Hour and
Public Contracts Divisions
U. S. Department of Labor

Classified Section

RATES: "Help Wanted" 20¢ a word, minimum $5.00. "Situations Wanted" 10¢ a word, minimum $2.00. "Business Opportunities" 15¢ a word, minimum $3.00. Box number, when used, is two words. Closing date, 10th of month preceding date of issue.

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CPA, nine years large and small firm tax and audit background available per diem in N. Y. C. or Westchester. Box 1621.

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BUSINESS OPPORTUNITIES

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The President's Page

The New Year

The year 1959 has every prospect of being another year of forward progress for our profession. The arrival of a new year is the traditional time to look back, re-examine, evaluate, and make plans to improve and better oneself. Certified public accountants in making their forward plans and resolutions might consider the following as advantageous to themselves and to their profession.

1. Stress the high standards of education and experience required of candidates in preparation for the CPA examination; and the professional skill, experience, and discipline required of CPA practitioners.

2. Emphasize the true value of the certified public accountant to business organizations, individuals, credit grantors, governmental organizations and others.

3. Make certain that you as a certified public accountant assume your proper responsibilities in your community and remember that public acceptance of certified public accountants requires continued and constant efforts to discharge all community obligations in a professional manner.

4. Observe the highest level of ethics and professional conduct and give to your clients your fullest competence and technical knowledge.

5. Keep fully informed on new techniques and developments in your profession through the use of professional literature, technical meetings and contacts with other practitioners.

6. Recognize your obligation to the profession by contributing wholeheartedly to its advancement.

7. Remember and practice the cardinal virtues of the certified public accountant—independence, integrity and competence.

HOWARD A. WITHEY,
President

Accounting Principles and Income-Tax Allocation

By Weldon Powell, CPA

After outlining the development of the doctrine of tax-allocation from its original statement in Accounting Research Bulletin 18 (1942) to the revised Bulletin 44 (1958), the author analyzes the merits and deficiencies of various approaches to the problem in the light of applicable accounting principles.

There always have been issues in accounting. They go with the exercise of judgment. There are problems before the profession today. In this article I should like to discuss some pertinent points in connection with one of them, namely, the allocation of income taxes. Along with price-level adjustments, it probably occupies the number one position among the issues that are being debated currently in accounting circles. It seems to me to have got out of hand, and that concerns me deeply.

Income-tax allocation is a relatively young issue, as issues go. This probably is because the conditions that have given rise to it are of recent origin. These, of course, are the existence of important differences in the determination of income as between the books and the tax returns, accompanied by sustained high rates of income tax.

Weldon Powell, CPA, *is a partner in the firm of Haskins & Sells, Certified Public Accountants. Mr. Powell is a member of the Committee on Accounting Procedure and chairman of the Special Committee on Research Program of the American Institute of Certified Public Accountants.*

Early References to Tax Allocation

The first reference to income-tax allocation that I can find in the Accounting Research Bulletins of the Committee on Accounting Procedure of the American Institute of Certified Public Accountants is in Bulletin 18, which was issued in 1942—only sixteen years ago. That bulletin was put out as a supplement to a 1939 bulletin dealing with unamortized discount and redemption premium on bonds refunded. The accounting for bond refunding operations was pertinent at the time because there were many sizeable ones. It was considered acceptable to dispose of the unamortized discount and redemption premium on the refunded bonds, either by a direct charge to surplus, or by amortization over the remainder of the original life of the issue. For income-tax purposes, however, both the unamortized discount and the redemption premium were deductible immediately and, accordingly, the tax payable for the year in which the refunding occurred was less than it

otherwise would have been, in some cases by a material amount.

Bulletin 18 dealt with this situation in the following summary statement:

"Where unamortized discount on bonds refunded is written off in full in the year of refunding, it is sound accounting to show such charges as a deduction in the income statement in the year of refunding in harmony with the treatment required for income tax purposes. Where any write-off is made through surplus it should be limited to the excess of the unamortized discount over the reduction of current taxes to which the refunding gives rise, and there should be shown as a deduction (as hereinafter described) in the income statement for the year of refunding an amount at least equal to such reduction in current taxes.

"If the alternative of spreading unamortized discount over a future period is adopted, a charge should be made (as hereinafter described) in the income statement in the year of refunding equal to the reduction in current income tax resulting from the refunding."

The statement that it was sound to account for unamortized discount and redemption premium in harmony with the tax treatment apparently bothered the Committee, for it was rescinded five years later. Of course, the income-tax law never was a good criterion of sound accounting, and it is not today. In fact, the gap between tax laws and accounting principles seems to be widening. The income tax is becoming more of an excise tax, and I sometimes wonder whether we should not recognize it frankly as such.

I have always thought that the Committee had the right approach to differences between financial income and taxable income in Bulletin 13, issued in 1942, dealing with the accounting for special reserves arising out of the war. There it said:

"Recognition of the necessity of such reserves is important, not only in the interests of the business enterprise, but in the interest of the national economy as a whole. The government might well take account of this fact in its fiscal policies generally and in respect of taxation. It would be wise on the part of the government to give consideration to the recognition of provisions of this kind as deductions in the determination of taxable income, subject to necessary safeguards in regard to the ultimate disposition thereof. Such a policy would tend to make taxable income more nearly reflect real income, since these reserves are intended to give recognition to costs and losses related to the war period which are real, though in many cases they cannot now be definitely measured."

Bulletin 13 did not call for allocation or other adjustment because of the different treatment of provisions for war reserves as between the books and the tax returns.

It was, then, the problem of how best to account for and report upon bond refundings that got the profession involved in the allocation of income taxes. Incidentally, Bulletin 18 was not adopted unanimously. Of the twenty-one members of the Committee, three dissented and three did not vote. The dissenters made this pithy comment:

"The dissenting members point out that the situation covered in this bulletin is only one of many instances in which accounting for general corporate purposes may differ from accounting for income taxes, and they, therefore, feel that there is no justification for singling out unamortized discount for special consideration. They are of the opinion

that adjustment should not be made in the income statement to reflect differences between corporate and tax accounting, because the income for the period would thereby be misstated; that reference to such differences by a footnote would ordinarily constitute adequate disclosure."

Material and Extraordinary Character of Differences

Two years after Bulletin 18—in 1944—the Committee issued Bulletin 23 on "Accounting for Income Taxes." It said in effect that income taxes are like other expenses, and that, accordingly, as to material and extraordinary items, where there is an interstatement variation (income statement versus surplus statement) or an interperiod variation (current period versus future periods) between financial income and taxable income, income taxes should be allocated; and it discussed the manner in which income-tax provisions and adjustments should be reported in financial statements.

Please note the words "material and extraordinary." Bulletin 23 was silent concerning small and recurrent differences between books and tax returns. But when, in 1953, it was re-written as Chapter 10, Section B of Accounting Research Bulletin 43, it was amplified to state that allocation does not apply where there is a presumption that particular differences will recur regularly over a comparatively long period of time.

Bulletin 23 did not have the unanimous approval of the Committee: there were three dissenters. After its issuance, it was warmly debated. Some persons thought it was not clear, at least in certain of its provisions. Others frankly disagreed with it, in whole or in part. However, the allocation principle had become sufficiently accepted by the time—1952—when Bulletin 42, dealing with "Emergency Facilities — Depreciation, Amortization, and Income Taxes," was released, so that the latter pronouncement, which called for accounting recognition, where material, of the income-tax effect of differences between book depreciation and tax-return amortization, was unanimously adopted and has been generally followed.

But Bulletin 42 adhered to the material-and-extraordinary-items idea set forth in Bulletin 23. It was intended to deal with situations in which, without some kind of income-tax allocation, there would be a reasonably certain swing of material size in the reported results of operations as between the present and the near future. The very subject of the bulletin—emergency facilities—indicates that the circumstances with which it was concerned were not ordinary ones.

Then, in 1954, the Committee, with one qualified assent and one dissent, issued Bulletin 44, entitled "Declining-Balance Depreciation." This Bulletin was intended to answer questions that had arisen following the recognition of certain accelerated depreciation methods in the Internal Revenue Code of 1954. The Bulletin said three things. The first two dealt with the acceptability of accelerated depreciation methods for accounting purposes, and the disclosure of changes in accounting arrangements when such occur. The third, and the one pertinent here, concerned situations in which an accelerated method is adopted for income-tax purposes but other appropriate methods are followed for financial accounting purposes.

As to this, Bulletin 44, as it was issued originally, said that, in the ordinary situation, deferred income taxes need not be recognized in the accounts unless it was reasonably certain that the reduction in taxes during the earlier years of use of the accelerated method

for tax purposes was merely a deferment of taxes until a relatively few years later, and then only if the amounts were clearly material. The language used, unfortunately, was not as clear as it might have been. In practice, it was interpreted as not requiring income-tax allocation with respect to depreciation differences related to so-called normal property additions and replacements, or to those which, in total, appeared to be of indefinite or permanent duration.

At this point I do not have very much difficulty with the allocation of income taxes as it has been applied in practice. Recent developments, however, seem to tend toward considerable widening of the area of application of the allocation principle. This troubles me.

A Reversal of Position Reflected in Revised Bulletin 44

Specifically, the Committee on Accounting Procedure in July 1958 issued a revision of Accounting Research Bulletin 44 which reverses the position taken in the original issue of the Bulletin. The revision provides that in situations in which an accelerated depreciation method is adopted for income-tax purposes but other appropriate methods are used for financial accounting purposes, accounting recognition should be given to deferred income taxes if the amounts thereof are material, except in certain rare cases, such as are mentioned below, where there are special circumstances which may make such procedure inappropriate. The text makes it clear that this is intended to apply even though the property additions involved represent normal replacement or expansion of facilities, the tax deferment is likely to be permanent (in total only, of course, but not for individual items), and the depreciation provision for financial accounting purposes will tend, in the long run, to equal that for income-tax purposes.

The rare cases envisioned by the Committee as being those in which accounting recognition need not be given to the deferment of income taxes, are such as where charges for deferred income taxes are not allowed by regulatory authority for rate-making purposes, and it may reasonably be expected that increased future income taxes, resulting from the earlier deduction of declining-balance depreciation for income-tax purposes only, will be allowed in future rate determinations. In these cases, of course, full disclosure of the circumstances is required.

By way of explaining the change in its position between 1954 and 1958, the Committee included the following paragraph in the revision of Bulletin 44:

"Since the issuance of Accounting Research Bulletin No. 44, the committee has been observing and studying cases involving the application of the bulletin. Studies of published reports and other source material have indicated that, where material amounts are involved, recognition of deferred income taxes in the general accounts is needed to obtain an equitable matching of costs and revenues and to avoid income distortion, even in those cases in which the payment of taxes is deferred for a relatively long period. This conclusion is borne out by the committee's studies which indicate that where accelerated depreciation methods are used for income-tax purposes only, most companies do give recognition to the resultant deferment of income taxes or, alternatively, recognize the loss of future deductibility for income-tax purposes of the cost of fixed assets by an appropriate credit to an accumulated amortization or depreciation account applicable to such assets."

Qualifications and Objections—Bulletin 44

Five of the twenty-one members of the Committee assented to the revision

with qualification, their qualifications in all cases constituting objections to or dissents from that part of the revised bulletin dealing with income-tax allocation. Two of them thought it did not go far enough. Although they commented separately and made their points somewhat differently, they both objected to the fact that the bulletin provided for certain exceptions; and they expressed their belief that generally accepted accounting principles should apply equally or uniformly to all business companies, including regulated companies, and that rules of regulatory authorities which contravene or conflict with generally accepted accounting principles should not be sanctioned or approved by public accountants for financial reporting purposes. On the other hand, two members of the Committee, of whom I was one, thought the bulletin went too far. They stated their belief that it called for more extensive income-tax allocation among periods of time than was necessary or desirable, especially where the situation was such that the so-called tax deferment was in effect a permanent tax reduction. These latter two members further objected, and the same objection was made by a fifth member, to the use of a bulletin on depreciation for making an important change in the Committee's views on the accounting for income taxes as set forth in a previous bulletin dealing with that subject (i.e., Bulletin 43—Chapter 10, section B).

The Issue As It Exists Today

Bulletin 44, as revised, seems to me to imply that if a little allocation is good, more of it is better, and a lot of it is just fine. It is a long way from the material-and-extraordinary-items approach taken in all of the Committee's previous pronouncements. I am afraid that history is about to repeat itself, and that in the same way that we let ourselves in for somewhat limited income-tax allocation in 1942 through consideration of the accounting for unamortized discount and redemption premium on refunded bonds, we are about to let ourselves in for almost general income-tax allocation in 1958 through consideration of the accounting for accelerated depreciation.

I think this is an important issue in accounting today. It is an issue that involves the largest single item of expense in many businesses, and one that goes to the heart of some fundamental concepts in accounting.

Here let me make it clear that I have no quarrel whatever with the allocation of a provision for income taxes as between the income statement and the surplus statement, when a substantial item in the determination of taxable income is charged or credited directly to surplus. On the contrary, I favor allocation in this case, no matter whether it means a charge or a credit in the income statement. My difficulties arise with some of the proposals for allocation between the income statement and the balance sheet, that is, between periods of time.

Balance Sheet Credits Resulting from Tax Allocation

Many—probably most—of the situations in which income-tax allocation in this area has been advocated are those which would give rise to credits in the balance sheet. This is understandable in view of the conservative bent of most businessmen. The main approach to allocation in the United States, therefore, has been by way of recognition of deferred income taxes. This implies that there is a present liability for future income taxes.

But there is no such liability. There is no creditor. Certainly, the federal government recognizes no claim against

the taxpayer, and the taxpayer would react strongly if he thought it did. However, I want to point out parenthetically that if sizeable tax items build up on the liability side of many balance sheets, it is not impossible that the government may try to do something about them; it is not unlikely that pressure may be brought in the Congress to amend the law to require payment of these apparent obligations, or at least to prevent their further accumulation.

Some advocates of the allocation principle have recognized forthrightly that tax credits in the balance sheet are not liabilities. They have not agreed, however, as to just where such credits should be placed in the statement. Accordingly, there are reports in which the credits are classified as reserves for taxes, or deferred credits. There are other reports in which they are netted against asset items, as by being considered as additional allowance for depreciation. Bulletin 44, as revised, says that where it may reasonably be presumed that the accumulative difference between taxable income and financial income will continue for a long or indefinite period, it is alternatively appropriate, instead of crediting a deferred tax account, to recognize the related tax effect as additional amortization or depreciation applicable to such assets in recognition of the loss of future deductibility for income-tax purposes. And there are some public-utility reports in which tax credits are shown as a part of earned surplus, with the approval of regulatory authority. This variety tends to be confusing.

If a tax credit is expected to be long continuing, other problems arise. One concerns the tax rate which is likely to exist at the time it is disposed of. Some consider the present rate of 52 per cent realistic for use in this connection. Others favor different rates. A few advocate establishing tax credits initially on a present-worth basis, by the application of an appropriate interest factor. In some circumstances, particularly in the case of companies having small profit margins and frequent loss years, there well may be a question as to whether a long-continuing tax credit will ever be used at all. In most cases, the procedure to be followed in the future in disposing of tax credits is unsettled. Faced with these uncertainties, I wonder how much significance long-continuing tax credits have in the balance sheet.

Balance Sheet Debits Resulting from Tax Allocation

Cases have arisen, of course, in which income-tax allocation would produce debits in the balance sheet. These are instances in which losses or expenses, or provisions therefor, are recorded in the accounts before they become deductible for income-tax purposes, and those in which profits or income become taxable before they can be taken up for financial accounting purposes in conformity with generally accepted accounting principles. If there are doubts about whether a tax credit is a liability, there are more serious doubts about whether a tax debit is a good asset. It is not a receivable. Surely, the federal government would disavow it.

If it is not a receivable, it must be a cost that relates to a future period. This, of course, gets into the question of the basis of matching for income-statement purposes. Before I discuss that, however, I should like to call attention to the following footnote from the annual report of Servel, Inc. for the year ended October 31, 1956:

> It has been the policy of the Company to exclude from income all amounts received from the issuance of extended warranty contracts and to treat such amounts as reserves for the subsequent cost of carrying out such commitments.

For Federal income tax purposes, however, the amounts received for warranty contracts are includable in taxable income of the year in which received, whereas the costs incurred in providing warranty services become deductible only when the expenditures are made.

To avoid distortion of its income statements the Company in 1950 adopted the generally accepted accounting practice of deferring as a charge to income of future years the tax effect of the current net increase in the reserves, and in its financial statements applied such deferred tax effect against its warranty reserves.

Because of the losses from operations experienced by the Company in recent years and the effect of the five year loss carry-forward provisions of the Internal Revenue Code, the Company has re-examined its accounting policy of deferring such income tax effects and has concluded that such policy is no longer appropriate under the presently existing conditions. Accordingly, such policy has been discontinued and the amounts deferred in prior years, aggregating $1,439,800, have been charged to deficit account, with a resulting increase of an equivalent amount in the warranty reserves.

The foregoing seems to me to be a good illustration of the difficulties that arise in attempting to account for tax debits in balance sheets. It speaks for itself, and does not require further comment on my part. In summary, I conclude that, considered from a balance-sheet standpoint, there is not a very good case for allocation of income taxes among periods of time. I turn now to a discussion of the income-statement approach.

Matching of Costs and Revenues

One idea that has been advanced is that proper matching requires that provision for income taxes be made at a certain percentage of income before taxes, without regard to the relative timing of transactions as between the books and the tax returns. For some companies the rate of 52 per cent would be applied; for others, the rate might be an average that would take into consideration continuing differences between book and tax treatments of depletion of natural resources and the like. I take a dim view of this approach. It seems to me to be income equalization in disguise and to ignore the balance sheet completely. Nevertheless, I am afraid that this may be the logical result of the extension of the allocation principle if what appears to be the present trend continues.

An approach similar to this has been proposed in Canada, but only as to one element in the determination of income—depreciation—rather than to income in total. The Committee on Accounting and Auditing Research of the Canadian Institute of Chartered Accountants has suggested, in its Bulletin 10, that in cases where depreciation taken for financial accounting purposes is less than that allowed for income-tax purposes, there is a known tax reduction which is directly related to the excess of tax-return depreciation over book depreciation and may be deferred and taken into income as the depreciation taken earlier for tax purposes is provided for later in the books. This approach avoids the necessity of estimating future taxes, and has the advantage of relative simplicity. It therefore has some appeal.

Then there is the approach that attempts to find a basis of realism in both the income statement and the balance sheet. It has natural appeal since it attempts to find a rational basis within the framework of existing concepts. The argument proceeds this way. Tax deductibility gives value to an asset (or a service, for that matter). The fair value of an asset whose cost is not tax-deductible is less than the fair value of an otherwise identical asset whose cost is tax-deductible. Therefore, the using up of the deductibility should be recognized in matching costs and revenues for purposes of determining income. To be specific, when the same depreciation

method is used for a given asset, for both book and tax-return purposes, there is appropriate matching of income taxes and revenue. When, as a result of using different methods, book depreciation is less than tax-return depreciation, allocation is necessary to charge against income, as a cost, that part of the tax deductibility attaching to the asset, which has expired. What is the measure of the cost? The tax differential. So goes the argument. According to it, the related tax deferral has balance-sheet standing because it is necessary to be considered in stating costs correctly in future periods.

A logical corollary of this proposition, it seems to me, is that the amounts equivalent to the tax differential should be carried through depreciation accounts, if a depreciable asset is affected. This makes a tax differential not a tax item at all, but simply a part of the measure of the cost of using an asset. This approach has considerable plausibility. My principal difficulty is that it bases the cost of service in part upon the profitability of the enterprise, and I doubt that this is sound theoretically.

A Realistic Approach

Nevertheless, although I do not think there is much of a case for allocation of income taxes, as between periods of time, from the standpoint of accounting theory as we now know it, there may be reason for its continued limited use. For one thing, I think we probably have gone too far to be able to retrace our steps to the beginning and start over. For another thing, there are specific situations, involving material and extraordinary items, in which allocation of income taxes may produce results which are more meaningful than they otherwise would be. I should like to suggest the following as a realistic approach to the problem.

Income taxes are a cost of doing business which happen to be measured by income, as income is defined by statute. I would start with the presumption that the tax paid or payable for a given period should be shown as a charge in the period for which it is paid. I would depart from the presumption only to correct an obvious distortion of income or to avoid an income presentation which might be misleading. In other words, I think the presumption should be against allocation.

Generally, of course, it is desirable that an income tax follow the income on which it is based when all of a given year's income is taxed in the same year. The difficulty arises when part of it is taxed in one year and part of it is taxed in another year. For example, if a tax payable in a certain year is for the privilege of doing business in that year but is computed on the income of the preceding year, there is no doubt in my mind about the desirability of charging the tax against the income of the preceding year although legally it did not accrue in that year. Otherwise, a situation could arise in which a substantial operating income is reported in one year with no tax against it, and an operating loss is reported in the succeeding year with a large tax added to it. Reports prepared accordingly would not be as meaningful as they should be.

However, when the income year and the tax year correspond, but a given item which enters into the determination of income for accounting purposes in one year does not become taxable, or allowable for tax purposes, until the succeeding year, I do not think that the tax necessarily should be computed on the book income at the going rate and that an accrued liability or an accrued receivable necessarily should be shown in

the balance sheet representing the tax effect of the item which presumably will enter into the tax computation in the future. My reasons for this are developed in the ensuing discussion.

All differences between income for accounting purposes and income for tax purposes do not have the same characteristics, and their tax effect should not be dealt with in the same way in all cases.

Factors of Materiality and Recurrence

Cases may be distinguished on the basis of size. Some items are large; others small. There obviously is greater necessity for accounting recognition of a tax effect which clearly is material in relation to income than of one which clearly is insignificant. I think that allocation should be confined to items which are clearly material.

Also, cases may be distinguished as to recurrence. Some items are expected to come up each year over a long period of time, whereas others are not expected to occur soon again if at all. There probably is more reason to account for the tax effect of a single item than of a regularly recurring one. I think that in most cases allocation should not be required in respect of regularly recurring differences. When the same item is expected to exist in about the same amount each year indefinitely into the future, I see no good reason to require adjustment for its tax effect under ordinary circumstances. I recognize that the cumulative impact on surplus in relation to dividends may require consideration, but I believe that in most cases this is a disclosure matter only.

Effect in the Future

Further, cases may be distinguished with reference to effect in the future. Some differences between the books and the tax returns never reverse themselves. Because the tax laws do not accord entirely with generally accepted accounting principles, some items in the determination of income for accounting purposes never get into the tax computation, and some items in the tax computation never enter into the book income. Other differences reverse themselves gradually over extended periods of time, or at some indefinite time in the distant future. Still others reverse themselves in the near future, possibly in the succeeding year. As to all of these, there possibly is greater need for adjusting income when the future effect is expected to be soon, is reasonably certain, and can be determined accurately, than when the future effect is not expected for a long time, may be uncertain, and cannot be estimated precisely.

Permanent Differences

I think that as to permanent differences between the books and the tax returns, consideration should be given to adjusting income for the tax effect when the contra would be to an asset, a liability, or a reserve. I think further that the necessity for allocation is greatest in respect of differences between one year and the succeeding year, and that it diminishes as the period of time lengthens between the original difference and its reversal. Allocation between this year and next year can be made with reasonable assurance. Allocation between the present and the last year of existence of a flourishing business is hazardous. When there are tax reductions or tax increases each year for a number of years, which cumulatively build up over a period of years to a permanent credit or debit, I would advocate that accounting recognition of the tax reductions or tax increases be not required.

Book Income In Excess of Taxable Income

In addition, cases may be distinguished as to direction. In some, the book income is more than the taxable income, and in others it is less. In the former, the effect is to report some income without any provision for tax against it, and in the latter, the opposite condition exists. There possibly is more cause to account for the tax effect in the first case than in the second. I think that providing for taxes which may have to be paid in the future in respect of certain items of income reported this year can be supported on the grounds that overstatement of income is bad and that possible future liabilities should be estimated and recorded if feasible. But I also believe that omission to defer a part of the taxes actually paid for this year can be defended on the grounds that deferral in this case would mean taking into current income an unrealized profit and taking into the balance sheet an unknown asset which, in view of the difficulty of evaluating the eventual realization, might better be omitted. I need not dwell on the vagaries of the tax laws.

Regulated Companies

In the case of a regulated company, I have the definite feeling that the treatment which regulatory authority accords to tax differentials for rate-making purposes is paramount in arranging the accounting. Unless these are taken into consideration, there is not a proper matching of costs and revenues. I am not suggesting, of course, that simply because a governmental commission says something it must be so. What I am saying is that if a public utility company's rates are arranged by regulatory authority so as to permit the company to realize certain revenues in a given period in order to enable it to meet certain costs in that period, then meaningful reporting requires that the revenues and the related costs both be included in the income statement in such period. This is the principle, as I understand it, which is expressed in paragraph 8 of the revision of Bulletin 44, quoted earlier in this article.

Informative Disclosure

Disclosure seems to me to be very important in connection with tax differentials. Actually, this may be the crux of the matter. There is no disagreement between the proponents and the opponents of income-tax allocation that, although the income statement reports on past performance, many persons who use it do so with the future in mind, and consider it useful largely to the extent that it is valid as a basis for this purpose. The disclosure of tax differentials is important, therefore, not only to explain the past, but also to facilitate appraisal of the future. Where significant amounts are involved, they should be displayed prominently, per share as well as in total.

In almost all cases where the provision for income taxes shown in the income statement appears to be out of line in relation to the net income for the period, there should be some kind of an explanation. This may be given in any one of several ways. In a simple situation it may be included in the body of the income statement itself, as part of the description of the provision for income taxes. In complicated circumstances a lengthy footnote may be necessary to make the situation clear. Occasionally it is desirable to show the tax differential at the bottom of the income statement, both in total and per share, so that its relation to the reported net income may be readily apparent; this may be the case espe-

cially where relatively large amounts are involved and the financial statements are to be used for credit purposes. Sometimes it is appropriate to state also what the net income would be if adjusted for the tax differential.

Some persons believe that accumulated differences between the books and the tax returns generally are pertinent and should be mentioned also. This may be so in exceptional circumstances, but it seems to me that disclosure of differences which affect the income statement usually is more important.

All of the foregoing applies to allocation between periods. As I have already stated, I am in favor of allocation between the income and surplus statements. I have an open mind about allocation within the income statement, believing that what is desirable here varies with circumstances. In summary, I view income-tax allocation as essential in some circumstances, preferable in others, and undesirable in a number of situations. I regard it as an emphatic way of disclosing an important matter—nothing more, nothing less.

Statement Analysis and Historical Reporting

As auditors, the inadequacies of historical reporting in meeting the analytical needs of owners, creditors, employees, and others requires serious consideration. We have an obligation, not yet reflected in practice, to insist that the client provide sufficient supplementary data in connection with his financial statements (they *are* his, you know, not yours) to facilitate analysis by outsiders. The outsiders have their own concepts of value and their own standards of comparison. Some of them may be interested in the relative attractiveness of alternative investments. They may, for instance, want to compare return on invested capital for a given company with that of other companies in the same type of business. It is important that they have, as a minimum, sufficient supplementary data to make it possible for them to determine, perhaps with the assistance of their accountants, that the figures they are comparing are comparable. Such data might include indication of the current replacement cost of lifo inventories, the inventory at cost if it is valued at the lower of cost or market, the acquisition dates and costs of major parts of the plant and equipment, data on the sales mix and a conversion of revenue and expense data for, say, the past ten years into common dollars based on the entity's own price and cost structure. There is a mass of entity data, unobtainable elsewhere, which is needed for intelligent decision-making on the part of persons outside management. Our reporting standards will eventually have to expand to embrace at least some minimum portion of this supplementary data.

WILLIAM L. RABY, "The Worthlessness of Value,"
BULLETIN OF THE ARIZONA SOCIETY OF CPAs, November 1958

Accounting for Research and Development Costs

By MATTHEW F. BLAKE, CPA

Section 174 of the 1954 Internal Revenue Code has had the effect of reducing the gap between tax accounting for the costs of research and experimentation and conservative business practice. The enactment was well timed, occurring just a few years before the sputnik-stimulated concentration of effort in the sciences. Most of that activity is traceable to disturbed world conditions and the race into outer space, but Section 174 by itself would have induced a higher degree of research work. There is little doubt that the right of current charge-off tends to prompt industry to open the catch on its pocketbook. Through the current deduction privilege afforded by Section 174(a), industry pays only 48 per cent of the year's cost of probing into the unknown, which often is a bargain price for laying open the opportunity to realize rich rewards in the future. While research is inherently risky, the availability of a current tax deduction narrows the odds. The potential benefits to the country as a whole are too obvious to merit comment.

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Financial Accounting

The accounting profession has not issued an official bulletin concerning the handling of research and experimental costs in financial statements. Hence, it may not be overly presumptuous to offer the writer's interpretation of the principles which seem to have developed.

Research is not an easy matter to define with any degree of clarity. What is research in one company's accounts may have an entirely different name tag in another company's. Product and production research usually are classified as manufacturing costs but it is not unusual to find them among administrative expenses and in some companies, much to the sales manager's horror, they are found among selling expenses. The terms research and experimentation as used herein deal only with the development of products and production equipment and machinery. Excluded are such matters as marketing, personnel, and management studies, as well as drilling and exploration for natural resources.

Because management's purpose in authorizing a research program is to create values having a useful life extending beyond the years in which the

ED. NOTE: Some portions of this article have been adapted by the author from a paper presented by him at the Sixteenth Annual N.Y.U. Institute on Federal Taxation.

expenditures are made, there virtually always is some logic to the deferment of costs of active projects to the years to be benefited. Prior to the enactment of Section 174, the courts seized upon this premise as sufficient reason for requiring capitalization. But business practice has differed and it is a rare balance sheet which carries research costs as an asset. Purchased patents, processes, etc., are an exception but a moment's reflection provides a sound reason for the distinction. Research has to do with mere possibilities—the visionary and the untried, while in the acquisition of the product of another's research not only has the research been brought to a point of fruition, but a dollar value has been set in an arm's length transaction. This distinction brings into focus the reasoning that has prevailed among accountants in the conflict of cost matching and conservatism.

While there are many types of research there probably are no more than two types of researchers in the business world: (a) the continuous research activity carried on by separately established departments or divisions, and (b) the single project type which may be carried on by the assigned personnel as a full-time or part-time activity. The former is usually found among large companies but there is an increasing tendency for smaller companies to pursue the same course. In either set-up, the efforts of company personnel may be supplemented by universities, foundations, and research companies.

Where research is a continuing activity there is little reason for capitalization in order to match costs because the expenditures tend to average out over the years. An exception could be a well advanced project of comparatively heavy cost and with a high likelihood of success. Under the latter circumstances, deferral may not merely be permissible, but conceivably could border on the area of necessity in order to reflect fairly the results of operations and the financial position of the company. Where research is spasmodic and relates to but one project, the principle of conservatism is the governing factor in the absence of reliable evidence that the research will be successful.

In summary, it seems fair to observe that a sort of presumption in favor of current charge-off has developed, to be applied in the absence of reasonable assurance that the research expenditures of one year will produce profits or cost reductions in later years.

Divergent Tax and Accounting Treatment

What about the situation where a company wants the current deduction benefits of Section 174(a) but is reluctant to reduce the year's earnings in reporting to stockholders? If we may judge from the regulations under Section 446, the Internal Revenue Service intends to reduce to a minimum the permissible differences in treatment between the books and tax return. This constitutes the reversal of a time-honored policy. However, this restrictive attitude does not extend to research. Such expenditures are therein referred to as coming under a category of "accounting treatment for special items." Revenue Ruling 58-78 interprets this language to mean that there may be different treatment of research costs for tax and statement purposes without opening the door to a contention by the Government that the taxpayer has lost its rights to report under Section 174.

The income tax regulations pertaining to applications for changes in election or method require the taxpayer to agree that upon approval by the Commissioner, he will make an accounting segregation on his books and records of

the expenditures to which the change in method or election is to apply. But this does not require conformity between financial statements and tax returns. Rather, it is concerned with the necessity of maintaining records which are sufficiently complete to permit review by Internal Revenue Service examiners and, accordingly, proper records which are maintained independently of the books should be sufficient.

The applicability of deferred federal income tax credits to research, along the lines of Chapter 10 of Accounting Research Bulletin No. 43, is dubious. Where a material distortion of income results because research costs have been expensed for tax purposes but capitalized on the books, the same rationale which led to the issuance of the Bulletin is pertinent. However, it is apparent that in most instances the need for deferred tax credits would be comparatively small in the case of research since the life expectancy and profit-making potential of a research project are less certain than in the case of buildings, machinery and equipment.

Prior Law

The 1939 Code contained no provision specifically dealing with research expenditures and, as a consequence, there was an unceasing debate among taxpayers, the courts, and the Internal Revenue Service as to the proper tax treatment of research and experimental costs. The courts early laid down the rule that the expenditures should be capitalized,[1] although there were decisions pointing in the other direction[2] (this still must be considered as the law[3] wherever Section 174 does not apply). Taxpayers were not discouraged and in general deducted costs of research and experimentation as ordinary and necessary business expenses except where their tax situations were served better by capitalization.[4] Paradoxically, the Service usually adopted a more liberal approach than the courts and tended to allow deductions where the expenditures had been incurred under a continuing research program.[5] Nevertheless, some examining agents took the position that part or all of such expenditures should be capitalized particularly where there were possibilities of obtaining patents. The position of the Service was less liberal with regard to new taxpayers and those only sporadically engaged in research.

Enactment of Section 174

In response to insistent demands by taxpayers for legislative correction, and with Presidential and Treasury support, Congress in 1954 remedied the unsatisfactory situation by enacting Section 174 which now provides reasonable certitude of tax treatment for an activity which must be regarded as one of the mainstays of our economic progress and may prove to be responsible for our survival in this age of nuclear fission and long-range missiles.[6]

The new provision specifies two methods for treating research and experimental expenditures. The expenditures may be treated as expenses and deducted as incurred or they may be deferred and amortized. Combination of the two specified methods is permissible only with the approval of the Commissioner. Where no choice is made, the expenditures will be dealt with under existing case law.[7] Section 174 relates to the cost of the company which would own the end product of the research and not the costs and expenses incurred by the engineering or research company which is retained to perform service for others. As the benefits to the engineering company stem from sales income for performing a research job for others, its expenditures

would be cost of sales, or the equivalent for tax accounting purposes. It seems fair to state that most of the difficulties which occur under the present statute will be the result of the taxpayer's own choosing, a distinct improvement over the uncertainties which existed under the old law.

What are Research and Experimental Expenditures

Section 174 contains no general definition of research and experimental expenditures and makes no attempt to distinguish between basic and applied research. Instead, a few types of expenditures are specifically excepted from its application. The Regulations, however, make an effort to delineate the area and, in so doing, limit the term "research and experimental expenditures" to those expenditures which represent research and development costs in the "experimental or laboratory sense."[8] Thus, the term includes generally all such expenditures incident to the development or improvement "of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property," but it does not include expenditures for research "in connection with literary, historical, or similar projects."[9]

Under this definition, it may be doubted whether research costs incurred in the library would qualify if the end result sought were a book, treatise or paper. If related to a specific research project, library costs would be allowable. Moreover, costs incurred in developing a market for a new product rather than in developing the product itself probably would not constitute research or experimental expenditures under the Commissioner's rules, although probably deductible as a business expense. This limitation of the scope of Section 174 is probably in line with Congressional intent in view of the apparently purposeful insertion in the statute of the word "experimental" instead of the more usual and broader term "development." However, the latter is employed in the Regulations so it should not be considered to bear an unwelcome connotation.

Experimental or Pilot Models

Inclusion of "an experimental or pilot model" as research cost, is essential to carrying out the will of Congress and indicates the extent to which liberalization has been achieved. However, many questions concerning such tangible properties remain unanswered. For instance, will the right to current deductions be affected if the pilot model of a chemical process plant eventually may be used as a demonstrator for sales purposes? Or, suppose the manufacturer of a product likely to be destroyed in testing builds two or more prototypes simultaneously, does the use of the article "an" have a limiting effect? While no categorical answers can be ventured at this time, it would appear that intent should play the decisive role. If the primary motive for construction of the model is research in the "experimental or laboratory sense," the costs should be considered as deductible even though the pilot model eventually becomes a sales tool, or despite the fact that more than one prototype is necessary so that the work can be continued in the event one unit is destroyed accidentally or purposely during the experimental process.

Certain Exclusions

Two types of expenditures are expressly excluded from the research and experimental category: (1) those for the exploration of minerals, oils and gas which are now covered specifically under Sections 615 and 263(c),[10] and

(2) those for the acquisition or improvement of land or of property which is subject to the allowances for depreciation or depletion and is "to be used in connection with the research and experimentation."[11]

The restrictions relating to expenditures for the acquisition or improvement of land and property subject to depletion allowances normally will present no difficulty, but the exclusion of expenditures for depreciable property used in connection with research is likely to result in disputes. The purpose of the limitation is to prohibit charging the cost of a new research laboratory or equipment to expense, doubtless on the theory that they are available for use on more than one project. The wording of the limitation, however, is vague as to whether the expenditures to be excluded are confined to costs of component materials, labor and other elements involved in construction and installation, or whether they also include amounts expended for preliminary research and experimentation. Applied literally, Section 174(c) would appear to exclude the research costs incurred in the development of depreciable research property as well as the cost of the physical property itself. It may be doubted, however, that this incongruous result was intended in view of the fact (to be later discussed) that costs of research and experimentation resulting in depreciable property not to be used in connection with research do qualify as research and experimental expenditures under Section 174.[12]

Although expenditures for the acquisition of depreciable or depletable property to be used in research activities are excluded, allowances for depreciation and depletion constitute research expenditures under Section 174.[13] This treatment would appear to have tax accounting significance only to the extent that it applies or is apportioned to research projects deferred under Section 174(b). In this case, the depreciation would be accumulated as a deferred cost until the point at which benefits are derived; taxpayers using the current expense method would be entitled to deduct current depreciation or depletion under Sections 167 and 611.

Depreciable Property Having Other Uses

Another occasion for capitalization relates to research resulting in depreciable property as an end product which is or can be used in the taxpayer's business. In such circumstances, deductions are limited to the amounts spent for research or experimentation. In the example given in the Regulations[14] the taxpayer expended $30,000 in the development of a new machine, of which $20,000 is deductible as research, and $10,000 represents labor, materials and other costs of constructing the machine, which amount is to be capitalized as a depreciable asset. The example appears to assume that the new machine is to be placed on the production line and is not merely a pilot model. Difficulty undoubtedly will be encountered in establishing a cut-off point between the termination of research and the construction of the end product, particularly where production personnel work on the research phase of the project.

Patent Applications

In a reversal of the proposed Regulations, the costs involved in making and perfecting a patent application are considered by the final Regulations to constitute research and experimental costs.[15] This represents a salutary departure from prior thinking[16] and should help considerably in dealings with Internal Revenue Service examiners. As long as the exception stood it was a serious stumbling block, not only because of the

difficulty of isolating patent application costs but, by reason of the time lag in acquiring patents, examiners were inclined to disallow a wide variety of costs as attributable to patents to be obtained in the future. This change has cleared the air considerably.

Single Projects

The Regulations state that the expenditures to which Section 174 applies may relate to a single project[17] and do not have to stem from a general research program. Hence, it would seem that a company having no permanent research department, which undertakes a lone research project, or a company or a joint venture set up solely to develop a new product would qualify. Net operating loss carry-overs are small consolation to a corporation which must rely on the success of the research program in order to utilize the same. Consequently, entrepreneurs with other sources of income to be offset will tend to favor unincorporated types of organization in order to obtain immediate deductions for such losses. Similarly, two or more industrial concerns which are entering upon a combined research program should consider the advantages of the joint venture form.

Expenditures Incurred in Trade or Business

In order to qualify under Section 174 the expenditures must be incurred in the taxpayer's trade or business.[18] While this restriction should have no effect on business operations, it may operate to deny the benefits of the section to the part-time inventor. The long line of pre-1954 cases granting capital gains treatment to backyard or basement inventors on the ground that they were not in the business of selling their inventions[19] now may be turned against them by the Treasury.

Research Expenditures vs. Purchased Items

The opening sentence of Section 174 expressly limits the application of the Section to expenditures paid or incurred by the taxpayer himself. This probably indicates an intent to exclude the costs of acquiring another's patent, model or process. The Regulations categorically take the position that the purchase price of another's "patent, model, production or process" does not constitute a research or experimental expenditure.[20] While the courts may uphold the Treasury's position, the legislative history of Section 174 lends some support to the opposite contention. In the hearings before the Senate Finance Committee, the Under Secretary of the Treasury gave the cost of buying a patent as an example of an expenditure coming within the proposed provision.[21] However, this may have been an unintentional misstatement of the Treasury's position. Assuming that the rationale of Section 174(a) in allowing current deductions for what otherwise would be subject to capitalization rests primarily on the unpredictability of benefits from research, there is merit in making distinction between research expenditures and the purchase of a patent, model, etc. The purchased item usually will have reached an advanced stage by reason of the research efforts of the seller and hence the buyer at arm's length vouchsafes that the property has an ascertained value by the very act of making the purchase.

Expenditures to Research Contractors

In any event, Section 174 is not confined to expenditures for research and experimentation undertaken directly by the taxpayer. It also applies to expenditures for such work carried on in its behalf by another person or organization such as a research institute,

foundation, or engineering company.[22] However, to the extent that the amounts paid by the taxpayer to his contractor represent expenditures for the acquisition or improvement of land or for the construction and installation of depreciable property of which the taxpayer will acquire ownership, they are not expenditures to which Section 174 relates.[23]

In connection with this limitation, the Regulations give an example indicating that taxpayers who have adopted Section 174(a) may profit taxwise by purchasing research rather than by undertaking it directly. In the example, the taxpayer hires a research organization to conduct research and experimental work in order to create a new product. In the taxable year, the taxpayer pays the organization $150,000, of which $25,000 is expended for an addition to the organization's laboratory and the balance for experimental work in connection with the project. It is agreed that the laboratory addition paid for by the taxpayer shall be retained by the research organization upon completion of the work. The Regulations state that the entire $150,000 represents research and experimental expenditures.[24] Accordingly, if the taxpayer had adopted the current expense method of accounting for research expenditures, he would be entitled to deduct that amount in his return for the year in which the expenditures were incurred. The case would be different if the taxpayer had undertaken the project itself and had spent $25,000 either in constructing a new laboratory or in adding to existing facilities. In this situation, the taxpayer's deduction would be limited to $125,000, and, under Section 174(c), the $25,000 paid for the new laboratory facilities would have to be capitalized and depreciated. Because of the extended amortization period, this thought does not apply with equal force to those who have selected Section 174(b).

Costs of research and experimentation incurred in connection with the construction or manufacture of depreciable property by another qualify as expenditures under Section 174 only if made upon "the taxpayer's orders and at his risk."[25] It is not unusual for a taxpayer to order a specially-built machine from an engineering company under a guarantee by the latter that the machine will be capable of producing a given number of units per hour. Since the research expenses were not incurred at the buyer's risk, the engineering company would be the experimenter and not the buyer. On the other hand, the research expenses would be deductible by a taxpayer on the current expense method if the machine were purchased without the performance guarantee as the outcome of the research then would be at the risk of the taxpayer.[26]

Ordinary and Necessary Business Expenses

Although often of only academic importance, one of the difficulties confronting taxpayers in applying Section 174 is the distinction between research expenditures and ordinary and necessary business expenses. The statute is silent here, but the Regulations do set forth a few types of expenditures which the Treasury regards as not falling within Section 174, such as "those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising or promotions."[27] Since this list does not purport to be and, in the nature of the case, cannot be exhaustive, taxpayers normally will have to decide for themselves how to classify a given expenditure. Probably the decision is

unimportant for those taxpayers who adopt the current expense method of treating research expenditures because their expenses, whether for research or for ordinary business purposes, are deductible in the year in which incurred. But taxpayers electing to defer research expenditures under Section 174(b) will have to be more careful. As the statute operates, it may be a number of years before such a taxpayer can claim a deduction for his deferred expenditures; to the extent that these expenditures represent ordinary and necessary business expenses, they could be disallowed in later years as part of deferred costs and consequently lost as deductions if the year in which they were incurred is barred by limitations when the examiner makes the disallowance.

Treatment of Research and Experimental Expenditures as Current Expense

Section 174(a)(1) permits taxpayers to deduct research or experimental costs as a current expense of the year in which paid or incurred. By and large, this provision gives statutory recognition to the administrative practice of the Service[28] and overthrows the restrictive precedents established by the courts under the 1939 Code.

A taxpayer wishing to deduct his expenditures currently must "adopt" the method in his return for the first taxable year beginning after December 31, 1953 and ending after August 16, 1954 in which he has research or experimental expenditures.[29] Adoption of the method requires merely that a deduction for the expenditures be claimed in the return.[30] Thus, the automatic method of adopting this method applies alike to those taxpayers who had such expenses in the first year of the 1954 Code and to those who initiated their first projects in a later year.

A taxpayer who passes up the current expense method in the first taxable year in which he could have done so may seek the Commissioner's consent to adopt it for subsequent years. The taxpayer's application must be filed not later than the last day of the first year for which the method is to be adopted, and, if granted, is applicable to that year and subsequent years. Prior years remain unaffected. It is too early to know what standards the Service will apply in acting on these applications.

The current expense method, once adopted, whether with or without consent, applies to all research and experimental expenditures for the taxable year and for all subsequent taxable years unless authorization is secured from the Commissioner to use a different method with respect to certain projects or to all of such expenditures. The opportunity to obtain permission to treat less than all of its expenditures as current expense allows a taxpayer to defer the cost of a special project without losing the tax benefit to be derived from deducting currently the remainder of his research costs. In no event, however, will a taxpayer be permitted to deduct part of the cost of a particular project and, in the same taxable year, to treat the balance of the expenditures attributable to the project under a different method.[31]

Following is a summation of the complex provisions concerning changes from one method to another:

1. A taxpayer who has capitalized all research or who has applied Section 174(b) only to specified projects may apply to the Commissioner under Section 174(a)(2)(B) for permission to adopt Section 174(a), and does not have to give any reason for requesting the change.[32]

2. Taxpayers who have adopted Section 174(a) may apply under Section 174(a)(3) for permission to change to

Section 174(b) or to the capitalization method for part or all of their future expenditures; reasons must be supplied for requesting this type of change.[33]

3. Those deferring costs under Section 174(b) may apply under Section 174(b)(2) for permission to change to Section 174(a) or to the capitalization method for part or all of their expenditures; reasons must be given on the application for change.[34]

The about-face in the final Regulations relating to the treatment of patent acquisition costs will require some taxpayers to take action. As pointed out earlier, such costs are now considered to be research expenditures and, therefore, are deductible under Section 174(a).[35] Taxpayers who adopted the current expense method in returns filed prior to the issuance of the final Regulations and who capitalized patent acquisition costs as required by the proposed Regulations should consider filing refund claims.[36]

Treatment of Research and Experimental Expenditures as Deferred Expenses

Under Section 174(b), a taxpayer who has not adopted the current expense method may elect to defer the cost of some or all of its research or experimental projects and amortize them ratably over a period, to be selected by the taxpayer, of not less than 60 months beginning with the month in which the taxpayer first realizes benefits. In all likelihood, the complexities and other drawbacks of Section 174(b) will prove to be far out of proportion to its utility factor.

An election under Section 174(b) is not required to have a fixed scope in contrast with Section 174(a). Under the latter subsection, the taxpayer must deduct currently all research expenditures until and unless he obtains the Government's approval to change to another method for some or all of its projects. It is true that if the taxpayer elects to bring all of its projects under Section 174(b), it is bound by that election in future years. But, management may prefer to limit its election to certain specified projects. Those projects not covered by such an election would have to be capitalized and would be governed by the case law under the 1939 Code. As a taxpayer who follows the individual project approach does not become frozen under Section 174(b) with respect to subsequent projects and needs no Governmental consent to elect 174(b) or to capitalize, it has a new choice for each new project, but, the choice is limited to Section 174(b) or capitalization. Under the circumstances, it would seem prudent not to make a broad election under Section 174(b) but to confine the election to individual projects even where in a given year the election to use Section 174(b) encompasses all projects started during that year.

To recapitulate, the elective privileges contained in Section 174(b) may come into play in any one of the following ways:

1. For taxpayers who have not adopted Section 174(a):

(a) Apply Section 174(b) to all expenditures.[37]

(b) Apply Section 174(b) to specific projects[38] and capitalize all other projects as though they were governed by case law under the 1939 Code.[39]

2. Where Section 174(a) has been adopted and the prior approval of the Commissioner is obtained, Section 174(b) may be applied to specified projects.[40]

The statute indicates that in order to qualify for elective treatment, the expenditures must be "chargeable to capi-

tal account."[41] Possibly, this is intended to exclude minor projects meant to benefit the current year, as well as items like administrative overhead and real estate taxes allocable to the research department. As a major premise of Section 174 is that research costs are intrinsically of a capital nature, it does not appear to constitute an exclusion of great importance.

The election under Section 174(b) does not apply to any property which at the same time is subject to depreciation or depletion allowances.[42] Research expenditures which produce a patent or any other property having a determinable useful life must be capitalized and depreciated. The cost of non-patented end products of the taxpayer's research, including secret processes and formulae whose useful life is indefinite, would qualify for amortization under Section 174(b). These were the expenditures for which there was no satisfactory treatment under the old law.[43] Where the depreciation is in itself a research cost, such as depreciation on a laboratory building, it becomes a research expenditure to be amortized together with the other deferred costs.[44]

Election of Method

The election may be made for any taxable year beginning after December 31, 1953 and, to be effective, must be made no later than the due date, including extensions of time, for filing the return for the taxable year in which the project was started.[45] This does not mean that the election must be for the first taxable year in which there are research expenditures as is required when the current expense method is adopted. But, the statute does deny an electing taxpayer the advantage of hindsight, since the election cannot apply retroactively to include costs incurred in prior years.[46]

The election under Section 174(b) is made by attaching a statement to the return for the year in which the project is initiated. In addition to other information, it must indicate "whether the election is intended to apply to all expenditures within the permissible scope of the election, or only to a particular project or projects." If the latter, detailed information identifying the project or projects to which the election is to apply must be included.[47]

The words "permissible scope" as used above are intended to exclude those not "chargeable to capital account" and to limit the election to those expenditures which result in property having an indeterminate useful life. As discussed later, expenditures which produce a patent would be excluded from deferred costs at the time the patent is granted. Similarly, expenditures on projects which are abandoned before benefits are realized will be excluded at the time of abandonment and charge-off. Since it usually will not be known at the time of the election whether given expenditures actually will result in property amortizable under Section 174(b), or will result in property with a determinable life, a taxpayer using Section 174(b) has many uncertainties ahead of him.

Period of Amortization

The statement to be attached to the return for the year in which the taxpayer elects to defer the expenditures must also indicate "the number of months (not less than 60) selected for amortization of the deferred expenses for each project."[48]

Thus, a taxpayer who has more than one project may select a different amortization period for each one. Unless the taxpayer standardizes by using the minimum five-year period for all projects, selection of periods will be a

difficult matter. The amortization period originally selected must be adhered to in the absence of authorization to change to a different period.[49]

Expenditures deferred under a Section 174(b) election are deductible ratably[50] over the period selected by the taxpayer (which may not be less than 60 months), beginning with the month in which the taxpayer first "realizes benefits" from the expenditures.[51] Since the election must be made shortly after the expenditures are incurred, a substantial period of time may elapse between the taxpayer's election and his first enjoyment of benefits from the expenditures. Thus, at the time of making the election the taxpayer may not know (1) whether the expenditures will result in any benefits, (2) when the benefits, if any, will begin or how long they will endure, and (3) whether the expenditures will result in the development of depreciable property such as a patent.

Postponement of amortization until the taxpayer first "realizes benefits" from the expenditures brings about a lack of assurance as to when deductions will begin. The Regulations take the position that, "in the absence of a showing to the contrary," a taxpayer will have begun to realize benefits in the month when he first puts the property to which the expenditures relate to an "income-producing use."[52] Whether a process becomes income-producing at the moment it is utilized in manufacturing new products or at the time when the first sales of those products are made is not clear from the Regulations. Surely, the income-producing test may also be satisfied by a machine or process which reduces costs or expenses; in this case it may be easier or more difficult to demonstrate when benefits were first realized depending upon the circumstances. Perhaps the words "in the absence of a showing to the contrary" prefacing the statement of the test in the Regulations promise lenient and flexible administration by the Service. But, no matter how modest they may be, some benefits must be realized before amortization can begin. This does not mean that if no benefits are realized a tax deduction will be lost. Should a project fail completely, the taxpayer would be allowed a loss deduction in the year in which it becomes worthless and is abandoned.[53]

Research expenditures sometimes culminate in depreciable property after benefits have been realized and amortization has begun. For example, a manufacturer may develop a special process resulting in a new product which is marketable. He elects under Section 174(b) to defer the research costs related to the process. A patent is applied for and is granted two years after he first realized benefits. While the patent is pending, the manufacturer is entitled to amortize the deferred research costs. But after the patent is granted, amortization under Section 174(b) ceases because the statute expressly makes the deferred expense method inapplicable to research costs chargeable to depreciable property.[54] The Regulations do not require retroactive adjustments but allow depreciation of the unrecovered cost under Section 167.[55]

An electing taxpayer who has realized benefits is apparently required to continue ratable amortization of his research expenditures over the period selected even if the benefits prematurely diminish or cease because of an advance in technology or other reason.[56] The underlying reasoning seems to be that, unlike the deduction for depreciation which is related to the useful life of the asset, amortization under Section 174(b) continues over a period arbitrarily selected by the taxpayer which will coincide only fortuitously with the duration of benefits. If a project be-

comes worthless prior to the end of the amortization period, an application for change in accounting method should be filed with the Commissioner requesting a foreshortening of the amortization period.[57]

Royalties from patents constitute personal holding company income under Section 543(a)(1). Where a personal holding company status looms in the future it could be profitable taxwise to defer costs under Section 174(b) in order to match them against such royalties.

Expenditures under Section 174(b) represent additions to basis under Section 1016(a)(1),[58] and, conversely, deferred expense charge-offs must be applied to reduce basis under Section 1016(a)(14). Since the latter section requires that the basis adjustment be not less than the amount allowable, taxpayers should be careful to claim in each year the full amount of amortization deductions to which they are entitled so as not to lose the full tax benefit. Since reduction of basis is required only to the extent that amortization results in a reduction of taxes, alertness in record keeping is essential.

Expenditures as Capital Assets

The values stemming from expenditures under Sections 174(a) and (b) appear to constitute capital assets as defined in Section 1221 of the Code and not depreciable assets under Section 1231(b). Upon sale there would be capital gain under Section 1222, or capital loss under that same section as limited by Section 1211. The point warranting elaboration is that where the unamortized cost of a Section 174(b) asset exceeds the selling price, depending on the circumstances, the loss may not bring about any tax benefit or may result in only a limited tax benefit. The reasoning is that a Section 174(b) asset is not "property used in the trade or business" within the meaning of Section 1231(b) because it is not subject to depreciation under Section 167. Hence, when a taxpayer follows the Section 174(b) route he should bear in mind that deferment of expenditures may lead to an unallowable capital loss. On the other hand, those who adopt Section 174(a) do not run this risk because of the current charge-off of expenditures.

Capitalization of Research and Experimental Expenditures

As indicated earlier, the Regulations require that taxpayers who do not bring themselves within Section 174 must capitalize their research and experimental expenditures.[59] This treatment is in line with virtually all of the cases decided under prior law.[60] Capitalized costs related to a project having a determinable useful life must be amortized or depreciated, or may be deducted as a loss if the project becomes worthless and is abandoned. On the other hand, where the project has no determinable useful life, as with secret processes, formulae, etc., the costs are recoverable through a loss deduction upon proof of worthlessness.[61] If the useful life of the project is indeterminate and there has been no abandonment, the Code provides no means whatsoever of recovering the costs except upon termination of the taxpayer's business. Even where a project has been abandoned, it may be difficult to prove worthlessness to the examining agent. With Section 174 available, it seems unlikely that informed taxpayers will subject themselves to the tax uncertainties of the capitalization method.

Factors Governing Choice of Method

It is probable that the great majority of taxpayers will choose to deduct their research and experimental expenditures under Section 174(a). It will appeal to

most taxpayers because the "bird in the hand" approach is their dominant philosophy. The uncertainties inherent in the capitalization of research expenditures under the 1939 Code also beset the deferred expense method, although to a lesser degree. The taxpayer cannot be sure when he will get his deduction under the deferment method or how much it will be. If the taxpayer's hopes and money are not translated into success to the point of realizing some benefits, the Service will require a showing that the research project and other projects related to it have been permanently discarded from the business before the loss deduction will be allowed. Moreover, under both the capitalization and deferred expense methods, deductions may be lost through failure accurately to segregate costs among research projects. The current expense method obviates the elaborate cost accounting systems required when expenditures are capitalized or deferred because the expenditures are deductible currently without regard to the success or failure of the projects to which they relate. It was in part the difficulty of allocating the specific costs applicable to various projects and processes that induced the Service, prior to the enactment of Section 174, to permit the current deduction of research costs to large companies with continuing research operations. With the current deduction now sanctioned by statute, there would seem to be, in the usual case, no reason why a taxpayer should expose itself to these vexations. Further, the current expense method may be used effectively to offset other income of the owners of a new undertaking which assumes an unincorporated form.

Although deduction as a current expense normally is advantageous, there may be special situations in which the deferred expense method will be preferred. For example, a new corporation (or a partnership whose members have no other taxable income), engaged in research and anticipating losses in its early years, may feel that the five year carry-over of net operating losses is insufficiently long for it to obtain the maximum tax benefit from its research expenditures.[62] Again, where an excess profits tax is anticipated, deferment eventually may produce substantial tax savings. Deferment may also be preferred where there is no other income and it is expected that the end product of the research will be sold at a large capital gain.

In general, taxpayers operating profitably will be well advised to adopt the current expense method for the bulk of their research expenditures and to reserve use of the deferred expense method for a particular project or projects calling for such treatment. There are but few situations in which it is of advantage to elect the deferred expense method.

References

1. *Gilliam Manufacturing Co.*, 1 BTA 967 (1925); *Goodell-Pratt Co.*, 3 BTA 30 (1925); *Hart-Bartlett-Sturtevant Grain Co.* v. *Comm'r.*, 182 F(2d) 153 (8th Cir., 1950).

2. *Duesenberg, Inc.* v. *Comm'r.*, 84 F(2d) 921 (7th Cir., 1936); *Pittsburgh Screw and Bolt Corp.*, 2TCM 747 (1943); *Universal Oil Products Co.* v. *Campbell*, 49-1 USTC ¶ 9180 (N. D., Ill., 1948).

3. *Red Star Yeast Co.*, 25 TC 321 (1955).

4. *Pittsburgh Screw and Bolt Corp.*, note 2, *supra*. The tax treatment of research and experimental expenditures under the 1939 Code has been stated to be as follows: "No specific treatment is authorized by present law for research and experimental expenditures. To the extent that they are ordinary and necessary they are deductible; to the extent that they are capital in nature they are to be capitalized and amortized over useful life. Losses are permitted where amounts have been capitalized in connection with abandoned projects, and recovery through amorti-

zation is provided where the useful life of these capital items is determinable, as in the case of a patent. However, where projects are not abandoned and where a useful life cannot be definitely determined, taxpayers have had no means of amortizing research expenditures." Per Senate Finance Committee, Sen. Rep. No. 1622, 83d Cong., 2d Sess. (1954).

5. In 1952, Commissioner Dunlap stated before the Joint Committee on Internal Revenue Taxation that it was Bureau practice to permit the deduction of research costs in computing net income where the taxpayer "under its established method of accounting" charged such costs to expense. In support of the Bureau's position the Commissioner pointed to the following: (a) the difficulty of determining the specific costs applicable to various projects and processes; (b) that research expenses usually are a necessary part of most businesses and are consistently charged to expense by most taxpayers; and (c) that over the long term, allowing current deduction would not differ materially in tax result from requiring capitalization with deferred deduction. (525 CCH ¶ 6170.)

6. It has been estimated that the 1957 outlay for industrial research exceeded $7,300,000,000. See remarks of Dexter M. Keezer in New York Herald Tribune, Oct. 26, 1957, Sec. 2, p. 5.

7. Regs. Sec. 1.174-1.

8. Regs. Sec. 1.174-2(a)(1).

9. *Ibid.*

10. IRC Sec. 174(d).

11. IRC Sec. 174(c).

12. Regs. Sec. 1.174-2(b)(2).

13. Note 11, *supra.*

14. Regs. Sec. 1.174-2(b)(4).

15. Regs. Sec. 1.174-2(a)(1).

16. The proposed Regulations were to the contrary. The present Regulation represents a reversal of the Bureau's policy under the 1939 Code. See Commissioner Dunlap's statement before the Joint Committee on Internal Revenue Taxation, 525 CCH ¶ 6170.

17. Regs. Sec. 1.174-1.

18. IRC Sec. 174(a)(1).

19. *Beach* v. *Shaughnessy*, 54-2 USTC ¶ 9657 (N. D., N. Y., 1954). Under the 1954 Code capital gain may be available to an individual whether or not he is in the business of making inventions. Proposed Regs. Sec. 1.1235-2(d)(3).

20. Regs. Sec. 1.174-2(a)(1). The inclusion of the term production herein is somewhat puzzling.

21. "A concern might buy a patent or have a heavy investment for research in one year. The tendency has been in some cases to make them capitalize that and write it off over a period of years instead of charging it off over 1 year. Now, we suggest making it optional. A concern can write it off in 1 year or spread it over a period of years." Per Under Secretary Folsom in Hearings before Senate Finance Committee on HR 8300, 83rd Cong., 2d Sess. (1954) 105, 123.

22. Regs. Sec. 1.174-2(a)(2).

23. Regs. Sec. 1.174-2(a)(2); Sec. 1.174-2(b)(4).

24. Regs. Sec. 1.174-2(a)(3), Example (1).

25. Regs. Sec. 1.174-2(b)(3).

26. Where the contract contains no guarantee of performance the Regulations state that research expenditures are deductible under Section 174(a)(1) if "real doubt exists as to the capabilities of the process." Regs. Sec. 1.174-2(b)(3). This vague qualification is almost certain to produce argument between revenue agents and taxpayers. Moreover, it appears to go beyond the statute. If the taxpayer built the machine himself, there would be no doubt as to the deductibility of research costs incurred in connection with its development, whether or not the machine was certain to be successful. The result should be no different merely because the taxpayer hired another to perform the work.

27. Regs. Sec. 1.174-2(a)(1).

28. See Commissioner Dunlap's statement, note 5, *supra.*

29. IRC Sec. 174(a)(2)(A). The Regulations grant an extension of time, running to January 2, 1958, within which taxpayers may adopt, without consent, the current expense method or change from that method or from the deferred expense method to a different method, in returns for 1954 and later years which were due for filing before that date. Regs. Sec. 1.174-3(b)(4); Sec. 1.174-4(b)(3).

30. Rev. Rul. 58-356, IRB 1958-29, 10.

31. Rev. Rul. 58-74, IRB 1958-9, 9.

32. Regs. Sec. 1.174-3(b)(2).

33. Regs. Sec. 1.174-3(b)(3).

34. Regs. Sec. 1.174-4(b)(2).

35. Regs. Sec. 1.174-2(a)(1).

36. IRC Sec. 6511.

37. Regs. Sec. 1.174-4(b) (1) (iii).

38. *Ibid.*

39. Regs. Sec. 1.174-1.

40. Regs. Sec. 1.174-3(b) (3) (iv).

41. IRC Sec. 174(b) (1) (C).

42. IRC Sec. 174(b) (1) (C).

43. See statement of Senate Finance Committee, note 4, *supra.*

44. Regs. Sec. 1.174-2(b) (1).

45. IRC Sec. 174(b) (2).

46. Note 45, *supra.* An exception to the statement in the text is created by Regs. Sec. 1.174-3(b) (4) which permitted taxpayers who had adopted the current expense method in returns filed before January 2, 1958 to change to a different method without obtaining the Commissioner's consent. Similarly, taxpayers who had capitalized their expenditures or used Section 174(b) in those years were permitted to adopt the current expense method without consent. See note 29, *supra.* However, where the taxpayer had capitalized his expenditures the Regulations contain no provision which would have permitted a change to the deferred expense method.

47. Regs. Sec. 1.174-4(b) (1) (iii).

48. Regs. Sec. 1.174-4(b) (1) (v).

49. See Regs. Sec. 1.174-4(b) (2) for requirements governing applications for change from the deferred expense method to a different method or for change of amortization period.

50. An example from the Regulations indicates that the word "ratably" should be construed to mean "straight-line." Regs. Sec. 1.174-4(c).

51. IRC Sec. 174(b) (1).

52. Regs. Sec. 1.174-4(a) (3).

53. The Regulations support this statement by inference. See Regs. Sec. 1.174-4 (a) (3) which, immediately after stating the income-producing test, refers to Section 165 and regulations thereunder relating to abandonment losses.

54. Note 42, *supra.*

55. Regs. Sec. 1.174-4(a) (4).

56. Regs. Sec. 1.174-4(a) (5).

57. *Ibid.*

58. IRC Sec. 174(b) (1).

59. Regs. Sec. 1.174-1.

60. However, the Senate Finance Committee apparently thought that in a proper case research expenditures were deductible under the 1939 Code. See note 4, *supra.*

61. Regs. Sec. 1.165-1(c) (1). As an illustration of difficulty of proof see *Wah Chang Smelting & Refining Co. of America, Inc.*, 30 TC 84.

62. The new election under Subchapter S may alter this approach.

Depreciation Practice

Notwithstanding the apparent prevalance of managerial opinion to the contrary, actual depreciation practice in the United States remains firmly anchored to historical cost. There has been no concerted action to bring depreciation charges into line with company financial requirements. This is attributed to a number of factors, such as lack of knowledge relative to inadequate depreciation, the requirement that depreciation costs must be earned under prevailing competitive sales conditions, and tax regulations which limit depreciation charges to historical dollar expenditures.

Knowledge has not been widespread with respect to the fact that depreciation recovery based on the original dollar expenditure is inadequate. As plant facilities are used, the original number of dollars spent are recovered through depreciation. In many cases it is not until replacement is contemplated that there is realization of the need for additional funds to maintain productive capacity at the original level. At this point there is often a sudden recognition that the stockholders' equity has been dissipated, due in part to income tax payments on prior years' profits which were overstated as a result of not accruing sufficient depreciation to cover the real cost of facilities used in manufacturing the products sold.

N.A.A. Research Report No. 33, "Current Practice in Accounting for Depreciation," April 1958

Official Release

Scope of the Independent Auditor's Review of Internal Control

Issued October 1958 as Statement on Auditing Procedure No. 29 by the Committee on Auditing Procedure, American Institute of Certified Public Accountants.

1. The purpose of this statement is to clarify previous pronouncements relating to the scope of the independent auditor's review of internal control as it pertains to his examination leading to an expression of opinion on the fairness of financial statements. No attempt is made in this statement to consider the scope of reviews of internal control by the independent auditor for other purposes, such as special engagements involving systems surveys, revisions, etc.

Background and Discussion

2. The standard short-form report[1] includes the following sentence:

"Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances."

3. The generally accepted auditing standard relating to internal control is summarized in the standards of field work[2] as follows:

"There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted."

It is generally recognized that as a by-product of this study and evaluation, the independent auditor is frequently able to offer constructive suggestions to his client on ways in which internal control may be improved.

4. In practice, certain questions arise concerning the scope of the independent auditor's review of internal control because of the broad definition set forth in the Special Report on Internal Control issued by the committee on auditing procedure in 1949. The definition reads as follows:

"Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. This definition possibly is broader than the

[1] Codification of Statements on Auditing Procedure, page 16.
[2] Generally Accepted Auditing Standards, page 13.

meaning sometimes attributed to the term. It recognizes that a 'system' of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments. Such a system might include budgetary control, standard costs, periodic operating reports, statistical analyses and the dissemination thereof, a training program designed to aid personnel in meeting their responsibilities, and an internal audit staff to provide additional assurance to management as to the adequacy of its outlined procedures and the extent to which they are being effectively carried out. It properly comprehends activities in other fields as, for example, time and motion studies which are of an engineering nature, and use of quality controls through a system of inspection which fundamentally is a production function."

5. Internal control, in the broad sense, includes, therefore, controls which may be characterized as either accounting or administrative[3], as follows:

(a) Accounting controls comprise the plan of organization and all methods and procedures that are concerned mainly with, and relate directly to, the safeguarding of assets and the reliability of the financial records. They generally include such controls as the systems of authorization and approval, separation of duties concerned with record keeping and accounting reports from those concerned with operations or asset custody, physical controls over assets, and internal auditing.

(b) Administrative controls comprise the plan of organization and all methods and procedures that are concerned mainly with operational efficiency and adherence to managerial policies and usually relate only indirectly to the financial records. They generally include such controls as statistical analyses, time and motion studies, performance reports, employee training programs, and quality controls.

The extent to which organizational plans and control methods and procedures may be classified as accounting controls or administrative controls will, of course, vary in individual circumstances.

Conclusions

6. In the ordinary examination, the selection of auditing procedures, their timing, and the determination of the extent to which they should be followed will depend largely upon the auditor's judgment of the adequacy and effectiveness of the internal controls. This judgment is arrived at as the result of his study and evaluation (which may involve testing, observation, investigation and inquiry) of those internal controls which, in his opinion, influence the reliability of the financial records. In the course of his examination the auditor obtains appropriate knowledge of his client's organization and operations, on which he bases his selection of the internal control areas he proposes to evaluate. Accounting controls, as described in paragraph 5(a), generally bear directly and importantly on the reliability of financial records and would, therefore, require evaluation. Administrative controls, as described in paragraph 5(b), ordinarily relate only indirectly to the financial records and thus would not require evaluation. However, if the auditor believes that certain administrative controls, in a particular case, may have an important bearing on the reliability of the financial records, he

[3] In one sense all controls may be characterized as "administrative," even the accounting controls. The division being made here is for the purpose of distinguishing the accounting controls, with which the independent auditor is primarily concerned, from all other controls.

should consider the need for evaluating such controls. For example, statistical records maintained by production, sales or other operating departments may be considered by the auditor as requiring evaluation in a particular instance.

7. The committee has considered whether the part of the definition of internal control concerning the safeguarding of assets and the auditing standard concerning study and evaluation of internal control, taken together, are inconsistent with the statement in the Codification[4] to the effect that, in the ordinary examination, the auditor does not assume responsibility for the detection of defalcations and other similar irregularities. The committee sees no conflict in this regard since the objective of the audit program (which is designed, in part, as a result of the evaluation of internal control) is to provide a basis for the expression of an opinion on the financial statements, taken as a whole, and not to detect defalcations or similar irregularities. In developing such a program, the auditor has a responsibility for evaluating internal controls designed to safeguard assets, and when such controls are weak or lacking his program should take this condition into consideration. This consideration might lead either to the extension of audit tests, or to the shifting of emphases or timing of the audit procedures; for example, counts, reconciliations, confirmations, or observations of certain assets (such as cash, receivables or inventories) might be made at the balance-sheet date rather than at an interim date.

[4] Codification of Statements on Auditing Procedure, "Responsibilities and Functions of the Independent Auditor," pages 11-13.

Desirable Breadth of Service

Because of the rapidly increasing dependence of our economy on skillful business management, there is some current interest in the question of what the scope of public accounting should be; what are the proper and desirable bounds of accounting practice? This question is of interest not only to certified public accountants in determining their own policies, but also to educators in the field of commerce and business administration because of its bearing on the content and emphasis of an educational program in accounting. . . .

There is general agreement that the scope of the public accountant's services may properly be broad, beyond the recognized fields of auditing, accounting systems, and income taxation. In a competitive economic system one cannot justify on general grounds a restricted definition of the scope of services. If there is need for certain types of service such as consultation on office organization or analytic interpretation of financial data, such services will be made available and properly so by those most willing and capable of providing them.

At the present stage of business development there appears to be considerable need for consultation which is not adequately met by other expert advisors. In the case of small business, management cannot afford to seek counsel of separate specialists regarding all the different facets of their operations. Consequently, small businessmen often turn to their accountants, just as in many cases they turn to their attorneys, for general business consultation, because members of each of these professions can draw upon valuable experience outside the narrower confines of their particular fields and because through long association their clients have come to respect their judgment and common sense. . . .

Donald P. Perry, "Public Accounting Practice and Accounting Education," Dickinson Lectures, 1955

Members of our Society's committee on federal taxation discuss some of the major provisions of the Technical Amendments and Small Business Tax Revision Acts of 1958. The first three articles appeared in the December 1958 issue. The series will be continued in subsequent issues.

Article IV of a Series

Security Transactions

By HARRY Z. GARIAN, CPA

The investment fields had been yielding the finest crops of income-tax-savings ideas until the 1958 Act ploughed most of them under. The new provisions affecting security transactions have been designed primarily to close the so-called "loopholes." For better understanding, I will first point out the loopholes and then discuss how they have been knotted out.

In general, the new provisions are applicable to transactions occurring after December 31, 1957. However, the Treasury Department apparently reserves the right to contest prior transactions under such general theories as "not a transaction entered into for profit," and "substance over form."

Amortization of Bond Premiums

Section 13 of the Act brakes the rapid amortization of bond premiums on short-term call bonds. Taxpayers were using short-term call bonds to obtain an ordinary deduction in exchange for reporting a long-term capital gain; or to realize double deductions in the form of the premium amortization and a charitable contribution deduction. This opportunity resulted from the fact that the bond retained its value despite the lapse of the premium period; presumably because of the tax attractiveness of the rapid amortization feature available to the subsequent purchaser of the bond as against the investment feature of the bond.

For example, a bond issued in 1950 and callable in 30 days is purchased for \$106. The \$6 premium is immediately amortized and taken as an ordinary deduction. The bond continues to sell at \$106, the taxpayer holds it for six months, sells it on the open market and realizes a long-term capital gain of \$6. Assume that instead of selling it in the open market, the taxpayer sells it to a charitable organization for his adjusted cost basis of \$100. Since the market value is \$106, he claims a charitable contribution deduction for the excess value of \$6. This plus the amortization deduction of \$6 give him total deductions of \$12 at a cost of \$6.

The amortization of premium on taxable bonds acquired after December 31,

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1957 is to be determined by reference to the price of the bond and the period to maturity with one exception, that is, the call price and period are to be used if amortization by reference to them would result in lesser amortization. If a bond is called and there is an unamortized premium on the call date, it will be allowed as additional amortization deduction in the year the bond is called.

Dividends Received Deduction by Corporations

Section 18 of the Act restricts the 85 percent dividends received deduction allowable to corporate taxpayers.

Corporate taxpayers were able to use the dividends received deduction to convert ordinary income, short-term capital gains or long-term capital gains into 85 percent tax-free income. The taxpayer would purchase the stock before its ex-dividend date, take the dividend and sell the stock immediately afterward. The taxpayer would receive the dividend and pay tax on only 15 percent of it; on the other hand, 100 percent of the loss on the sale after the ex-dividend date (approximately the amount of dividend received) would be allowed. It would be a capital loss to an investor corporation and allowable against short-term or long-term capital gains, as the case may have been. If the corporation were a dealer in securities, the loss reduced the gross profit on the sales of securities. As a result of Section 18, the 85 percent dividends received deduction is denied on stock purchased after December 31, 1957, unless the taxpayer held the stock for at least 16 days (91 days for a preferred stock with dividend arrearages of over one year).

In determining the holding period for the purpose of counting the 16 and 91 days:

1. Exclude the date of acquisition but include the date of disposition.

2. Do not count any day which is more than 15 days (90 days for applicable preferred stock) after the ex-dividend date.

3. Do not tack on any holding period if the dividend has been received on reacquired securities subject to the wash sale rule.

4. Eliminate from the holding period the days in which the taxpayer has an offsetting option or obligation to sell, or an open short sale, with respect to substantially identical stock or securities.

Corporate taxpayers were also able to obtain an ordinary deduction in exchange for 85 percent tax-free income through short sales and the corporate dividends received deduction. A corporation could buy the stock long and sell it short immediately before the ex-dividend date. It would receive the dividend on the "long stock" and take an 85 percent dividend received deduction leaving only 15 percent in taxable income; on the other hand, it would be required to pay an equivalent dividend with respect to the "short stock" (that is, on borrowed stock) which would be an ordinary deduction. The new law denies the dividends received deduction if the taxpayer is required to pay a dividend with respect to a short sale of substantially identical stock made after December 31, 1957.

Capital Gain Dividends from Regulated Investment Companies

Section 39 limits the benefits of long-term capital gain treatment of capital gains distributions by regulated investment companies to all taxpayers holding stock of such companies for less than 31 days.

All taxpayers who had realized short-term capital gains could utilize regulated investment company stock to convert such short-term capital gains into long-term capital gains. A taxpayer purchased a regulated investment company stock shortly before a long-term capital gain dividend was to be paid, received the dividend and treated it as a long-term capital gain although the stock was held only for a few days. Then immediately afterward, the taxpayer sold the stock at a loss (approximately equal to the dividends received). The loss was a short-term capital loss since the regulated investment company stock had been held less than six months. The short-term capital loss was deductible against the short-term capital gains. Of course, a security dealer in the same situation could take the loss as an ordinary loss against gross profit on the sales of securities, thereby converting ordinary income into long-term capital gain.

The loss on the sale of regulated investment company shares purchased after December 31, 1957 must be treated as a long-term capital loss to the extent of the amount of long-term capital gain dividends received if the stock has been held for less than 31 days. The rules for determining the holding period are identical to those listed above for dividends received deduction purposes.

Bonds Issued at a Discount

Section 50 of the Act increases the restrictions on the use of original issue discount to convert interest equivalent into a long-term capital gain.

Section 1232(a)(2) of the 1954 Code as originally enacted had limited this device by requiring the lender to report an original issue discount as ordinary income to the extent attributable to the period held by the taxpayer. However, the Treasury Department understood that some corporations were issuing debt securities with artificially large discounts with the predetermined intention of calling them at par before maturity. In such situations, Section 1232(a)(2) did not prevent the holder from treating the portion of the profit attributable to the period after the call as a long-term capital gain. For example, a $100 bond, with ten years to maturity, is issued for $90. If after two years the bond is called at par, the holder would treat $2 as ordinary income (2/10 of $10) and $8 as long-term capital gain under the Code before amendment.

The entire gain on the disposition of bonds after December 31, 1957 is treated as a non-capital gain to the extent of the original issue discount ($10 in the above example), unless there was no intention to call the security before maturity at the time of original issue. The burden of proof is with the taxpayer—he must make a reasonable showing that there was no collusion involved at the time of the issuance (Senate Committee Report). If the taxpayer furnishes the required burden of proof, then the old rule applies.

The "original issue discount" is considered to be zero if it is less than one-fourth of 1 percent multiplied by the number of complete years to maturity. Therefore, a 20-year bond with a redemption price of $100 can be issued at $95.01 without the issue discount being treated as ordinary income under either the original 1954 Code provision or Section 50 of the 1958 Act.

Bonds with Coupons Detached

Section 51 of the Act completely invalidates the device of purchasing bonds with interest coupons detached as a means of converting interest equivalent into long-term capital gains. Section

1232(c) of the 1954 Code as originally enacted treated as ordinary income the gain attributable to detached coupons if any of the detached coupons became payable more than 12 months after the date of purchase. This apparently encouraged the practice of purchasing bonds without the coupons due within the 12-month period after purchase. A simple example would be the purchase of a 4 percent, $100 bond selling at $99 for $95, without the first two semi-annual coupons of $2 each. At the end of the year, it is sold for $99 (assuming no market fluctuation) so that the purchaser reports a long-term capital gain of $4 but no interest income.

A taxpayer must now treat as a non-capital gain the entire value attributable to the detached coupons ($4 in the above example) on bonds and other evidences of indebtedness purchased after December 31, 1957. The value attributable to detached coupons is determined by comparing the fair value at the time of the purchase with all of the coupons attached to the purchase price of the security ($99 less $95, or $4 in the above example).

Amortization of Tax-Exempt Bonds by a Security Dealer

Section 2 of the Act restricts a security dealer from utilizing its partial exemption from the tax-exempt bond amortization requirements to obtain tax-exempt income and a deductible loss equivalent to the bond premium amortization.

Under Section 75 of the 1954 Code, dealers were not required to amortize the premium on tax-exempt bonds held for sale to customers if (1) the bonds were disposed of within 30 days after the date of their acquisition, or (2) their earliest maturity date or call date was more than five years from the date of acquisition. By complying with either of the two exceptions, the dealer realized income that was tax-exempt and incurred a corresponding loss that was tax deductible. For example, if a dealer held for thirty days $100,000 of a 3.6 percent New York State bond purchased for $102,000 and due in two years, the interest income would be $300 and the premium expense would be about $80. If a dealer sold the bond within 30 days, he would sustain a loss of $80 (exclusive of gain or loss due to market fluctuation) which would be deductible. Thus, instead of treating $220 as tax-exempt income, he treated the entire $300 as tax-exempt income and the $80 loss as deductible. Alert security dealers turned over their tax exempts within 30 days or bought tax exempts which had more than 5 years to run to maturity.

In the case of tax-exempt securities acquired after December 31, 1957, neither the 30-day nor the five-year exception rules will apply, unless (a) the dealer sells the security at a profit, or (b) otherwise disposes of it at a time when its fair value exceeds its tax basis. In determining whether a security is sold at a profit, interest earned on the security is not considered and the basis of the security is not adjusted for the amortization of bond premium.

The adjustment for bond premium amortization is made in the year of sale if the taxpayer values his inventory at cost. As to dealers who value their inventory on a basis other than cost, the cost of goods sold for the year of the sale is reduced for the total premium amortization incurred by the taxpayer during the period he held the security, if a "more than five year bond" is not sold at a profit. No similar delay in reducing the cost of goods sold is necessary for "sold within 30 day bonds," since the taxpayer will

know if an adjustment is required within 29 days after the close of the taxable year.

Bond Losses, etc. of Banks

Section 34 of the Act restores the right of banks to take an ordinary deduction for losses resulting from the retirements of bonds, notes and other evidences of indebtedness issued by corporations or governmental units without interest coupons and in unregistered form. This right was inadvertently taken away in the drafting of Sections 1232 (a)(1) and 582(c) of the 1954 Code.

The 1939 Code required that an evidence of indebtedness be with coupons or in registered form in order for a retirement thereof to qualify as an exchange. Therefore, ordinary income or loss (bad debt) resulted from the retirement of a corporate note (even though a capital asset) not registered or without coupons, since the retirement was not a "sale or exchange." The coupon or registration requirements were eliminated in the drafting of 1954 Code Section 1232(a)(1) so that at present a capital loss results from the retirement of such obligations (if a capital asset) under the 1954 Code.

The 1939 Code permitted banks to treat a net loss on the sale or exchange of corporate or governmental debt securities "with coupons or in registered form" as an ordinary loss. In Section 582(c) of the 1954 Code, the requirement of "with coupons or in registered form" was continued, which was inconsistent with the change in Section 1232 (a)(1). Therefore, a bank could not claim a loss on the retirement of a corporate note (which was not registered and without coupons) as an ordinary loss under Section 582(c), or as a bad debt since there was deemed to be a note exchange under Section 1232(a) (1). This result was inadvertent since Congress did not intend to bar banks from taking an ordinary loss on such investments.

Section 34 eliminated the words "with coupons or in registered form" from Section 582(c) so that a bank may now take a loss on the retirement of a corporate mortgage as an ordinary loss. Of course, such ordinary loss treatment is available only if the bank sustains a net loss from sales, exchanges or retirements of all corporate or municipal obligations; a net gain from such transactions is treated as a capital gain. The above comments are not pertinent to obligations which do not constitute capital assets to a bank (such as a note acquired for services rendered).

The Section 34 amendment to Section 582(c) is effective as if part of the 1954 Code as originally enacted.

Earnings and Profits of Regulated Investment Companies

Section 101 closes an unintended benefit resulting from an oversight in the drafting of the 1954 Code.

Under the 1939 Code a distribution of ordinary income by a regulated investment company which sustained capital losses in excess of its ordinary income during a taxable year was deemed to be a taxable dividend to the extent of its ordinary income, even if there were no accumulated earnings and profits at the beginning of the taxable year. The rationale of not permitting regulated investment companies to deduct capital losses against ordinary income in determining the taxability of its current year's dividends is that the regulated investment company is treated as an income conduit for its shareholders, much as a trust is treated for tax purposes. However, as the 1954 provisions relating to regulated investment

companies were written, such company could avoid the application of the above rule by distributing less than 90 percent of its ordinary income as dividends. Of course, it would have to pay tax as an ordinary corporation but this would usually be limited to a 7.8 percent tax because of the dividends received deduction—a small price for a shareholder to pay indirectly to receive the income as a tax-free distribution.

Section 101 added a sentence to Section 852(c) which provides that the earnings and profits for the taxable year (but not accumulated earnings and profits) are not to be reduced for unallowable deductions in the current taxable year in the case of a company otherwise a regulated investment company, even though it fails to:

(a) pay out 90 percent of its ordinary income as dividends, or

(b) comply with regulations relating to the ascertainment of the actual ownership of its stock.

Thus, a regulated investment company is now prevented from disqualifying itself as such for the purpose of paying nontaxable dividends by merely failing to pay out 90 percent of its ordinary income as dividends.

The provision is effective only as to taxable years beginning on or after March 1, 1958. Therefore, calendar-year and January 31 fiscal-year companies can take advantage of this benefit for their years beginning in 1958.

Options to Buy or Sell

Section 53 of the Act, according to the House Committee Report, merely rearranges and clarifies the existing tax treatment with respect to options to buy or sell. Actually, this is the case of the tail wagging the dog. Section 53 of the 1958 Act is mainly a codification of the regulations issued under Section 1234 of the 1954 Code as originally enacted.

Section 1234, as originally enacted, was drafted in general terms. Then Section 1.1234-1 of the regulations issued specific rules, several of which were subject to being questioned as legislation rather than interpretation. These rules have been incorporated into Section 1234 by the 1958 Act. They are as follows:

1. Gain or loss from the sale or exchange of non-capital assets is treated as gain or loss on Section 1231 property or as ordinary income or loss, depending on the nature of the property covered by the option.

2. A dealer in options realizes ordinary income from the sale or exchange of an option.

3. Section 1234 does not apply to gains on the sale of an option to the extent income derived in connection with the option would be otherwise treated as ordinary income, such as the gains on employees' stock options, options on "Section 306 stock" and options which represent dividend distributions.

In addition, Section 1234(c) (4) codifies a comment contained in the Committee Reports under the 1954 Code as originally enacted (but not contained in Section 1234 as originally enacted or in the regulations issued thereunder) to the following effect:

If an option acquired before March 1, 1954 is a capital asset but the underlying property is a non-capital asset: (a) any gain on the sale or exchange of the option is a capital gain despite Section 1234, and (b) any loss on the sale or exchange of the option is an ordinary loss under Section 1234.

This amendment is effective as if enacted with the 1954 Code.

Short Sales of Stock by Dealers

Section 52 of the Act restricts the rights of a dealer to continue his holding period uninterrupted on an investment (capital asset security) if he makes a short sale of a stock substantially identical to the investment. Prior to this amendment, Section 1233(b) (rules relating to the postponement of the beginning of the holding period) applied only if the security used to cover the short sale was a capital asset; it did not apply if the dealer used an inventory security to cover his short sale. Thus, a dealer could realize a long-term capital gain and an offsetting ordinary loss, with the obvious tax benefits. For example, a security dealer bought a stock for his "Investment" account and on the next day sold it short for substantially the same price. If the security rose in price, after six months the dealer closed the short sale by applying the same stock from his "Inventory" account and took an ordinary loss therefor. On the other hand, he sold the "Investment" stock and took a long-term capital gain since the short sale rule postponing the holding period did not apply. If the security declined in value, he would cover the short sale with the investment security and have no gain or loss from the transactions.

In the case of a short sale made after December 31, 1957 which is not closed until more than 20 days after the date on which it was made, the holding period of a substantially identical investment security held for not more than six months will not begin until the date of the closing of the short sale. For the purposes of the new rules, an option to sell (put) shall be considered a short sale and the exercise or failure to exercise such option shall be considered as a closing of a short sale. Furthermore, the term "stock" includes convertible bonds and stock subscription rights. Note that the rules do not apply to short sales of bonds other than convertible bonds because the abuses were found to occur with respect to stocks.

Hedging Transactions—Short Sale Rules

Section 1233 has been amended to exclude hedging operations in commodity future entirely from the operation of the short sales provisions. This amendment is effective as if enacted with the 1954 Code.

Limitations on Charitable Contributions Deduction for Cash Basis Taxpayers

Section 12 of the Act denies any charitable contribution deduction to a cash basis taxpayer for the donation of prepaid interest and drastically reduces the charitable contribution deduction for the donation of income on a bond not received and not taxed if the bond was purchased or carried with borrowed funds.

A cash basis taxpayer borrowed money and bought a security (or other property), prepaid the interest on the liability, donated the property subject to the liability to a charitable organization and took a double deduction for the prepaid interest—once as an interest expense and again as a charitable contribution deduction. For a simplified example, an individual on the cash basis bought a $1,000 bond with his note for $1,000 with 4 percent interest. He paid the holder of the note $40 of interest in advance and then donated the property subject to the liability to a charitable organization. He was entitled to deduct (1) as interest the prepaid inter-

est expense of $40, and (2) as a charitable contribution the value of the donation given to the charity—the same $40 of prepaid interest. Under the new rules, the deduction for charitable contributions made after December 31, 1957 will be reduced for the amount of interest paid (or to be paid) which is attributable to (1) the liability attached to the property donated, and (2) the period after the making of the contribution. In the example given, there would be no charitable contribution deduction allowed.

Another practice of cash basis taxpayers affected by Section 12 was purchasing bonds with borrowed money and donating the bonds, subject to the liability, after income was accrued but before the income was received. For example, on January 2nd a taxpayer purchased a 5 percent bond, paying interest annually on January 1, with his $1,000 note bearing interest at 4 percent. He would pay the $40 of interest and deduct it as such and then give away the bond subject to the liability on December 31 before the income is payable to him. He deducted a charitable contribution deduction for the $50 of interest accrued, but not received or taxable to him, on December 31. Thus, by the payment of the $40 of interest, he received $90 of deductions, consisting of $40 in the form of an interest deduction and $50 in the form of a charitable contribution deduction. In the case of such gifts made after December 31, 1957, the charitable contribution deduction must be reduced for the amount of interest which has been paid (or is to be paid) by the taxpayer on the indebtedness incurred or continued to purchase or carry the bond which is attributable to the period before the making of the contribution ($40 in the above example). The reduction of the charitable contribution is limited to the amount of interest or interest equivalent on the bond which is attributable to any period before the making of the contribution and which has not represented taxable income to the taxpayer (this limitation applies only if the borrowing rate is higher than the bond rate). In the example given above, the charitable contribution would be reduced to $10 ($50 less the amount of interest expense relating to the period before the charitable contribution). The term "bond" includes debentures, notes or other evidences of indebtedness.

Financial Management

Financial management, in its last analysis, consists of an examination of the existing business and its various departments to determine the areas in which return on capital may be unsatisfactory and what steps should be taken to remedy such situations; a review of the estimates of other sources of capital within the business, considering especially the possibility of a reduction in operating capital requirements for current business; an examination of the possibility of re-financing to reduce the cost of capital, to make additional capital available, or to retire capital not needed; a re-appraisal of the common-dividend objective in the light of the entire financial programme; and the selection of the most important of the other demands for funds and the elimination or deferment of those which are less important or, if excess funds are available, an examination of possible additional uses for funds in the company.

Mary E. Murphy, "Accounting: A Social Force in the Community," Melbourne University Press, 1956

New York State Tax Forum

Guest Editor—STANLEY H. BECKERMAN, CPA

Distributions Arising From Unrealized Appreciation Subject to Tax as Ordinary Income

In a case of unusual interest to accountants and their clients, the New York Supreme Court, Appellate Division, Third Judicial Department, recently held that a corporate distribution arising from *unrealized appreciation of corporate assets* was taxable at ordinary rates to the individual shareholder, (*Marx* v. *Bragalini*, N.Y. Sup. Ct. A.D. 3rd Jud. Dept., 10/3/58). The amount of the distribution in excess of the stockholder's pro-rata share of the corporation's earnings and profits was taxed as ordinary income and the taxpayer's contention that such excess should be treated first as a return of capital and amounts in excess of tax basis treated as capital gain was rejected by the court.

The Facts. Reference to the record and the briefs in the case discloses the following facts.

1. Larchmont Apartments, Inc., a New York corporation, purchased an apartment house located in New York in March 1942 at a price of $1,700,675.49, subject to a first mortgage of $1,682,000 insured by the Federal Housing Administration.

2. The apartment house had not been constructed by Larchmont whose sole activities were the ownership and operation of the property.

3. After operating the property for more than eight years, the corporation obtained a new mortgage loan from an insurance company in the amount of $2,000,000 and issued its note as evidence of its obligation to repay said loan. This loan was not insured by the F.H.A.

4. The old first mortgage was satisfied and after payment of other costs, Larchmont received net cash proceeds of $824,810.60.

5. The assets of the corporation were reflected on its books at cost less depreciation and no adjustments were made to such values. No surplus was created on the books to reflect any appreciation that may have taken place in the assets and the board of directors did not make any revaluation of the property.

6. The reserve for depreciation at January 31, 1950 and January 31, 1951

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ED. NOTE: For an interim period, until a permanent departmental editor has been selected, this department will be conducted by guest contributors.

was in excess of $350,000 and $400,000, respectively.

7. On July 28, 1950, Larchmont made a distribution to its stockholders of $700 per share, a total of $735,000.

8. Larchmont had accumulated earnings of $77,911.31 at January 31, 1951 prior to reflecting the aforementioned distribution. Said earnings represented 10.60018 percent of the $735,000 distribution.

9. Taxpayer, *Marx*, received a total distribution of $389,588.89 on his 556 5/9 shares at the rate of $700 per share.

10. On his federal and New York State tax returns for the year 1950, taxpayer reported $41,296.42 (representing 10.60018 percent of $389,588.89) as ordinary dividends and the balance of $348,292.97 as a return of capital, subject to capital gains tax to the extent it exceeded the cost basis of his stock.

11. Upon examination of taxpayer's return for the year 1950, the federal Internal Revenue Service accepted this treatment of the distribution. The Internal Revenue Service also determined that the distribution of $700 per share was taxable to the shareholders of Larchmont as an ordinary dividend to the extent of 10.60018 percent.

12. On audit, the state Income Tax Bureau held that the entire distribution of $389,588.89 was "normal income." On review, the State Tax Commission made a final determination that $41,296.42 of the distribution represented a distribution of corporate earnings and the balance of $348,292.47, "represented a distribution of surplus earnings or profits resulting from an unrecorded appreciation of real property" and finalized the assessment of the entire distribution at normal tax rates.

The Argument. In the short space allotted to this Department, it is not possible to discuss in detail the legal positions advanced by the respective adversaries. However, in summary, the taxpayer argued that distributions in excess of the corporation's realized earnings and profits could not constitute "dividends" under the law and that such amounts constituted a return of capital. The Tax Commission argued that the distribution was taxable as dividends paid out of earnings and profits, albeit a portion was unrealized; alternatively, that the amount in question was not a capital gain and hence was taxable at ordinary rates as a part of "gross income."

The Decision. Although indicating that the petitioner made "an arguable case for a determination the other way," the court held for the Tax Commission that the entire distribution was taxable at ordinary rates.

Conclusion. Distributions which overcome the pitfalls of Section 341 ("collapsible corporations") and Section 312(j) ("distribution of proceeds of loan insured by the United States") of the Internal Revenue Code may clearly run afoul of the *Marx* case rationale for state tax purposes.

Unless this case is overruled in the Court of Appeals, accountants will have to give serious consideration to the fact that corporate distributions which qualify as a return of capital for federal income tax purposes may be subject to tax at ordinary rates by New York State.

Accounting at the SEC

Conducted by Louis H. Rappaport, CPA

Quasi-Reorganizations

The term *quasi-reorganization* in accounting means the procedure in the course of which a corporation, without creating a new corporate entity and without resort to formal court proceedings, is enabled to eliminate a deficit in earned surplus and to establish a new earned surplus account for the accumulation of earnings subsequent to the effective date of the quasi-reorganization. The SEC's views regarding quasi-reorganizations are stated in Accounting Series Releases Nos. 15 (1940), 16 (1940), and 25 (1941).

A quasi-reorganization is not considered by the SEC to have been effected unless all of the following conditions exist:

1. Earned surplus as of the date selected is exhausted;
2. Upon consummation of the quasi-reorganization no deficit exists in any surplus account;
3. The entire procedure is made known to all persons entitled to vote on matters of general corporate policy and the appropriate consents to the particular transactions are obtained in advance in accordance with law and charter provisions (see, however, p. 61);
4. The procedure accomplishes with respect to the accounts substantially what might be accomplished in a reorganization by legal proceedings—namely, the restatement of assets in terms of present conditions, as well as appropriate modifications of capital and capital surplus, in order to obviate so far as possible the necessity of future reorganizations of like nature.

Reductions in the carrying value of assets at the effective date may not be made beyond a point which gives appropriate recognition to conditions that appear to have resulted in relatively permanent reductions in asset values; as for example, complete or partial obsolescence, lessened utility value, reduction in investment value due to changed economic conditions, or, in the case of current assets, declines in indicated realization value. A procedure of this kind should not be employed recurrently but only under circumstances that would justify an actual reorganization or formation of a new company, particularly if the principal purpose of the quasi-reorganization is the elimination of a deficit in earned surplus.

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A clear report should be made to the stockholders of the proposed restatement and their consent obtained when necessary.

Full disclosure of the quasi-reorganization should be made in the financial statements for the fiscal year involved, and all subsequent statements of surplus should designate the point of time from which the new earned surplus dates. The SEC also states:

> . . . Until such time as the results of operations of the company on the new basis are available for an appropriate period of years (at least three) any statement or showing of earned surplus should, in order to provide additional disclosure of the occurrence and the significance of the quasi-reorganization, indicate the total amount of the deficit and any charges that were made to capital surplus in the course of the quasi-reorganization which would otherwise have been required to be made against income or earned surplus.

In February, 1956, the AICPA Committee on Accounting Procedure issued Accounting Research Bulletin No. 46 in which it stated that the dating of earned surplus following a quasi-reorganization would rarely, if ever, be of significance after a period of ten years. The Committee further stated that there may be exceptional circumstances in which the discontinuance of the dating of earned surplus could be justified at the conclusion of a period less than ten years. The writer understands that the views expressed in that bulletin are, in general, shared by the SEC, although the Commission reserves the right to consider other periods of time as appropriate with respect to discontinuance of dating of surplus in the light of specific circumstances. The writer does not view the SEC's position as constituting a qualified assent of the AICPA bulletin, since the bulletin itself seems to deal with ordinary cases in which the dating disclosure has no significance.

When the transfer of a deficit to capital surplus is effected by resolution of the board of directors but without approval of the stockholders, the SEC has additional requirements. In that situation it is necessary to make a complete disclosure of all the attendant facts and circumstances and their effect on the company's financial position in each balance sheet and surplus statement filed with the SEC thereafter. To effect the minimum appropriate disclosure in the surplus accounts, information should be given in respect of subsequent earned surplus in approximately the following fashion:

Total deficit to December 31, 1957	$700,000	
Less deficit at January 1, 1957, charged to capital surplus by resolution of the Board of Directors and without approval of stockholders, such action being permissible under the applicable state law	800,000	
Earned surplus since January 1, 1957....		$100,000

As an additional disclosure in cases where the write-off of deficit has not been approved by stockholders, the SEC requires, in the registration statement or other filing containing financial statements first reflecting the directors' action, that there be included an explanation of the action taken and an indication of its possible effect on the character of future dividends. For example:

> It should be noted that on (date) by action of the Board of Directors, without action by the stockholders, the company charged off a $............... deficit in earned surplus against its capital surplus. This procedure will permit the company in the future to reflect undistributed earnings subsequent to

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Administration of a CPA Practice

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, CPA

A Check List for Staff Members

One accounting firm has distributed to its staff a self-evaluation check list with the suggestion that each man sincerely and honestly question himself about each point listed. No report or other follow-up was involved. It was solely an introspective operation. The benefits derived therefrom, and there undoubtedly are some, would most likely develop slowly. There may, however, be instances where a man may be startled by the initial realization of an existing weakness or deficiency. The check list was introduced by an explanatory note pointing out that the successful accountant is the "well-rounded" man who satisfies employer and clients in the major areas of personality and competence. This is the check list:

MAX BLOCK, CPA *(N. Y., Pa.), is a former chairman of the Committee on Administration of Accountant's Practice of the New York State Society of Certified Public Accountants. He is a lecturer at the Baruch School of Business and Public Administration of The City College of New York in the graduate course on Accounting Practice. Mr. Block is a member of the firm of Anchin, Block & Anchin.*

1. Good technical knowledge; keeps current; general competence.

2. Managerial ability to organize and supervise a job efficiently.

3. Pleasant personality; neat appearance; modesty.

4. Conscientiousness; sincerity; integrity.

5. Ability to win clients' confidence; also to impress others.

6. Tenacity and thoroughness in following through.

7. Legible handwriting.

8. Knowledge of workpaper requirements; neatness and adequacy of papers; good organizer of papers.

9. Awareness of need for fullest cooperation with partners and office personnel (reviewers, tax department, etc.).

10. Ability to write well; speak well and convincingly.

11. Ability to develop constructive, analytical reports that are technically sound and deemed worthwhile and helpful by clients, bankers, etc.

12. Conduct as a professional man; polish; culture.

13. Businessman's instinct—with respect to clients' business operations, problems, and opportunities for new and special engagements for firm.

14. Sound instinct for system efficiency, organization efficiency, and personnel relations.

15. Alertness to his firm's interests with respect to client relations and profitability of engagement.

16. Sound and lively imagination—as reflected by ideas advanced as to tax savings, system suggestions, audit improvements, report improvements, etc.

17. Well informed on economics, finance, and worldly matters.

The "Passing Grade" Complex

A large percentage of students are content with a passing grade. Certainly they would like a very high grade but they readily settle for a passing grade. This permeates their attitude toward studies, examinations, and general performance. Accounting students are not differently constituted and many are content to receive average passing grades so long as they can obtain the coveted sheepskin. They, too, have indoctrinated themselves with the "passing grade" attitude.

Unfortunately this complex readily carries over to the job. Not all men can quickly, and successfully, change over to an *A* basis on the job when *C* or *D* was previously deemed satisfactory. This transition can be aided and accelerated by a frank discussion of the problem with an accounting staff initiate.

Do Staff Men Know Their Employers?

Where relations between staff men and their employers are not directly intimate, as is often the case, employees know little about their firm except the obvious and superficial knowledge that is obtained from their visits to the office and to clients, and staff chit-chat. This has some adverse effect on the "sense of belonging" which is so important a factor in men's development of sincere interest in their work and in their advancement of the firm's interests.

For example, do men know when the firm started, its record of partner and staff growth, its objectives for staff members, its efforts for client expansion as a means of providing opportunities for staff advancement, and other kindred points? If not, such information could be included in a staff indoctrination program, regardless of staff size. If the firm has enjoyed a satisfactory growth the message will have an inspirational value and give men a feeling of pride of association.

Some very large firms have prepared brochures for presentation to prospective clients when called in for an engagement discussion. These brochures contain information of a nature intended to acquaint the prospect with the accounting firm, its history, its organization, unusual experience, its specialization, departments, and such other professionally acceptable information as may be pertinent in the individual case. Staff men, if they receive similar information, would develop quickly an awareness of who their employer is, with some inevitable resultant benefit to the firm and to themselves.

Payroll Tax Notes

Conducted by SAMUEL S. RESS

Wage and Hour Law—New Salary Tests

On February 2, 1959, new salary requirements for the exemption of administrative, executive and professional employees from the Fair Labor Standards Act will go into effect.

Under the revised salary tests, an executive employee to be exempt from the minimum wage and overtime pay provisions must be paid a salary of at least $80 a week instead of the $55 heretofore required. Administrative and professional employees, to be so exempt, must be paid at least $95 a week instead of the former $75 per week minimum, under Regulation 541.

The special proviso for administrative, executive or professional employees qualifying for the exemption under shortened duty tests will require that such employees be paid a salary of at least $125 a week instead of the $100 provision in effect prior to February 2, 1959, in order to avoid the overtime pay requirement at the rate of time and one-half the regular hourly rate of pay.

SAMUEL S. RESS, *an associate member of our Society since 1936, is a member of the New York and Massachusetts Bar. He is engaged in public practice in his own office in New York City specializing in payroll taxation and labor-management matters.*

Dr. Ress is a member of the Society's Committee on New York State Taxation and chairman of its Subcommittee on Unemployment Insurance.

Higher Unemployment Insurance Rates In 1959

The 1959 unemployment insurance tax rates for New York employers will range from 0.7 to 3.0 percent of taxable payrolls. Employers whose tax payments were lower than the benefit payments charged to their accounts or who were late in filing reports will pay the 3 percent maximum rate. Increases in both the top rate and in the lowest rate result from legislative changes made last year and to stepped up withdrawals from the Unemployment Insurance Trust Fund. Official notices of individual employers' tax rates will not be issued until March 1959.

Recommendations for Changes in the Unemployment Insurance Law

At its meeting on October 7, 1958, our Society's Committee on New York State Taxation gave expression to certain legislative recommendations designed to eliminate several inequities with respect to unemployment insurance taxes and procedures. The following is a summary of these recommendations.

1. ARTICLE 18 OF THE LABOR LAW—*Section 591, Subdivision 3(d).* Recommended that this subdivision be repealed and deleted from the law in order to safeguard against the payment of unemployment insurance benefits to claimants receiving vacation pay for the same period of time for which they seek benefits. Employers having a layoff due

to lack of work either during the week prior to or the week subsequent to a paid vacation period are subjected to unreasonable charges against their account for experience rating purposes, making it virtually impossible for such employers to maintain a favorable balance in their account with the Unemployment Insurance Fund.

2. *Section 575.2—Delinquent Form LO-12 Report Penalties:*

(a) Recommended that Section 575.2 of the Unemployment Insurance Law be amended to eliminate the mandatory imposition of the $10 penalty for failure to file Form LO-12, Report for Wage and Employment Information, within the 7-day period from mailing or personal delivery date of demand for information unless failure to comply was due to circumstances beyond the employer's control.

(b) Alternatively, the 7-day period should be increased to a 14-day period. The amendment in 1958 permitting claimants with 15 weeks employment in the previous 52 weeks and 40 weeks employment in the previous 104 weeks prior to the week claimant applies for benefits in the new benefit year to qualify for benefits, may make it necessary for employers to obtain wage and employment information spreading over three calendar year periods. Thus, employers require more time within which to accumulate the information.

(c) The periods for measuring penalty should run from the date of receipt by the taxpayer to date of mailing the reply, not from the date of mailing the request to date of receipt of the reply by the Commissioner as at present.

Accounting at the SEC

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(date) as earned surplus, instead of as a reduction of the deficit charged off to capital surplus. One result of this procedure is to permit the distribution, as ordinary dividends, of earned surplus accruing subsequent to (date), without regard to the deficit charged off to capital surplus. Furthermore, if earnings subsequent to (date) are less than the deficit written off, distributions thereof may in effect represent distributions of capital or capital surplus.

In the case of the quasi-reorganization of a parent company, the SEC holds that it is implicit in the procedure that the effective date should be recognized as having the significance of a date of acquisition of control of subsidiaries. Hence, dividends subsequently received from subsidiaries should be treated as income only to the extent that they are declared by subsidiaries out of earnings subsequent to the effective date. Likewise, in consolidated statements, earned surplus of subsidiaries at the effective date should be excluded from earned surplus on the consolidated balance sheet.

Federal Income Taxation

Decisions and Rulings — RICHARD S. HELSTEIN, CPA

Commentary — Committee on Federal Taxation

Chairman, HERBERT M. MANDELL, CPA

Decisions and Rulings

The Peurifoy Decision

We were disappointed that the decision of the Supreme Court in *Peurifoy et al* v. *Commissioner* (____US____, 11/10/58) added no illumination to the definition of "home" with regard to travel expenses "away from home." It held that the question involved in this case was one of fact not of law and that since the court below had correctly determined the facts, the Supreme Court would "not intervene."

The *Peurifoy* case involves the deductibility of living expenses of three construction workers while on a construction project away from their homes. The lower courts held that the deductibility turned upon the question of whether the employment away from home was "temporary" or "indefinite." The Supreme Court found that the facts indicated the employment to be "indefinite" as determined by the Fourth Circuit and therefore sustained that court's disallowance in a *per curiam* opinion.

It is unfortunate that the court did not rule upon the validity of the principle that the distinction between "temporary" and "indefinite" is determinative of whether the expenses were incurred "away from home." As the dissenting opinion of three of the Justices indicates, such a question is only one factor, and in and of itself should not be a determining one. Actually, as pointed out in the dissent, the question of law involved is a "construction of the statutory term 'home'." Did Congress intend that a "taxpayer who is forced to travel from place to place to pursue his trade must carry his home on his back regardless of the fact that he maintains his family at an abode which meets all accepted definitions of 'home'?"

Apparently the court granted certiorari with the intent to interpret some such questions, but, as it indicates in its decision, the presentation of the case to it was such that it "found it inappropriate to consider such questions."

Redemption of Stock

The Internal Revenue Service has announced that it will follow the decision of the Court of Appeals in the *Holsey* case (*Joseph R. Holsey et ux* v. *Commissioner*, CA-3, 1958 ___F(2d)___) and will not treat the purchase of one

shareholder's stock by the corporation as a dividend to the remaining stockholders *merely because* their percentage ownership of the corporation is increased.

The Commissioner distinguishes the situation where the stock of the retiring stockholder is in reality purchased by the remaining shareholder, but paid for by the corporation. Such a transaction will be considered a dividend to the shareholder who acquired the stock in accordance with the decisions in *Wall* v. *U.S.* (CA-4, 1947) 164 F(2d) 462 and *Louis H. Zipp* v. *Commissioner* (CA-6, 1958) ____F(2d)____.

The Commissioner elaborates further to explain that if the stock is sold to the corporation for less than its fair market value, "such surrender may be a gift or compensation" to the remaining shareholders. Conversely, if more than fair market value is paid for the stock, "this payment may be compensation . . . or a gift" to the surrendering shareholder (T.I.R. No. 109, 10/30/58).

The release leaves some doubt as to whether the amounts to be treated as "compensation" or "gift" are the differences between the fair market values and the amounts paid, or the full amount paid. A literal reading however would seem to indicate the full amount would be so treated.

Deduction Disallowed for Prepayment of Interest on Prepaid Deficiencies

A taxpayer on the cash basis underwent an examination of his returns for the years 1945 through 1950. As the result of the audit, in 1952 the taxpayer was orally advised at a conference of deficiencies for each of the years and of the intent of the Internal Revenue Service to assert civil fraud penalties for the years involved. The taxpayer agreed to the deficiencies (except for minor differences in the years 1949 and 1950) but did not agree to the penalties Because of this, no form 870 was signed. Nevertheless, the Commissioner did not issue either a 30-day letter or a 90-day letter because criminal charges were pending against the taxpayer at that time.

Because the deficiencies were substantial and the taxpayer wished to stop the running of interest, in 1952 he remitted to the Collector a check covering substantially the determined deficiencies plus interest thereon to such date. This was credited by the Collector to a "suspense account." Being on the cash basis, the taxpayer deducted the interest in computing his tax liability for 1952.

In 1955, the grand jury failed to indict the taxpayer for criminal tax evasion, and the Commissioner issued a 30-day letter. After several conferences, the taxpayer signed a form 870 which covered both the deficiencies and the civil fraud penalties. The deficiencies were then assessed and the amounts in the Collector's "suspense" account credited to the taxpayer's account.

Upon examination of the taxpayer's 1952 return, the Commissioner disallowed the interest deduction on the grounds that the remittance prior to assessment did not constitute payment of tax and interest, but was a mere deposit pending determination, and was therefore not deductible under Section 23(b), IRC 1939 (similar to Section 163(a), IRC 1954) since there was no indebtedness.

The Tax Court sustained the Commissioner, principally following the de-

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cision in ***Rosenman*** v. ***U.S.*** (1945, 323 U.S. 658) that the placing of monies in a "suspense" account does not constitute payment of the tax and that there could be no payment until there was an assessment. (*Fred J. Arheit*, 31 TC___ No. 7.)

The *Rosenman* case involved the question of when the statute of limitations began to run. The case of *Lewyt Corp.* v. *Commissioner* (CA-2, 1953, 215 F(2d) 518) cited by the court, involved the question of "paid or accrued" excess profits tax deficiencies for purposes of the net operating loss deduction. And *Busser* v. *U.S.* (CA-3, 1942, 130 F(2d) 537) relied upon by the court, involved the government's liability for interest upon the excess amount deposited by an estate *prior* to the filing of its return.

No cognizance was taken by the court of cases which appear more apposite to the instant situation where it was held that placing of monies in a "suspense account" does constitute payment for purposes of determining whether there exists a deficiency coming within the jurisdiction of the Tax Court (*McConkey et ux* v. *Commissioner*, CA-4, 1952, 199 F(2d) 892, *cert. den.; Stanley A. Anderson*, 1948, 11 TC 841; *Julius Bendheim* v. *Commissioner*, CA-2, 1954, 214 F(2d) 26). That this confusing situation was recognized by Congress is evident in the addition of Section 6213 (b)(3) to the 1954 Code which provides that assessment shall be made upon receipt of payment and, further, that if such payment is made after issuance of a 90-day letter, it will not deprive the Tax Court of jurisdiction.

Practice Before the Treasury Department

The Treasury Department has proposed two changes in Treasury procedure dealing with representation of taxpayers before the Internal Revenue Service.

The first is that the Internal Revenue Service will give examinations to applicants with "satisfactory evidence of education and/or experience" who are not eligible for enrollment as lawyers, certified public accountants, or former I.R.S. employees. The examinations will be less difficult than those currently given. A successful applicant will be given a card permitting unlimited practice before all levels of the Internal Revenue Service, subject to Treasury Circular No. 230. The first of these examinations is projected for June 1959.

The second proposed change is to permit *any* person who prepares a return for a taxpayer, whether or not enrolled to practice before the Treasury Department, to represent that taxpayer in connection with the particular return prepared, with or without the taxpayer's presence at the examination. Such representation is limited to the field audit and office audit branches of the district director.*

Commentary

Election by Real Estate Corporations Under Subchapter S

An election of a corporation made under Subchapter S is automatically terminated if more than 20 percent of the corporation's gross receipts is from rents, dividends, royalties, interest, annuities, and gains from sales or exchanges of stock or securities. The termination is effective for the taxable year in which the required percentage is exceeded. Inasmuch as most real estate

* Since this Department was prepared the final regulations with regard to practice before the Treasury Department were adopted. They will be discussed in the February 1959 issue. It should be noted, however, that the second proposed change does not appear in the final regulations pending further study by the Director of Practice.

corporations derive more than 20 percent of their receipts from rents, generally, such corporations may not qualify for tax-free treatment.

However, there may be the impression that if the rents do not constitute personal holding company income, an election made by such a corporation would not be automatically terminated. The possible basis for this belief is found in Section 1372 (a) (5). This section is titled "Personal Holding Company Income." If the title of the subparagraph is meant to define the types of receipts which would result in a termination, then the average real estate corporation would qualify for the election because rents are personal holding company income only where they constitute less than 50 percent of the gross income. However, if the title heading is only a broad description of the types of receipts listed, then the receipt of rents in excess of 20 percent would terminate the election.

It is significant that the phrase "personal holding company income" does not appear in the Senate Finance Committee Report. The general explanation of Code Section 1372 (e) (5) appearing therein states that the election to be taxed under Subchapter S terminates "if more than 20 percent of the corporation's gross receipts are derived from interest, dividends, *rents*, royalties *or other forms of passive income*." (Emphasis added.)

Code Section 543 has various distinctions and definitions as to what is to be considered as personal holding company rent, none of which appear in Code Section 1372 (e) (5). It would appear, therefore, that "rents" for Subchapter S purposes are *not* to be considered in relation to any personal holding company definitions; that any compensation for the use of real or personal property in excess of 20 percent of the gross receipts would terminate the election.

What penalties, therefore, would an electing corporation or its shareholders incur if an election was made and was held to have terminated? If there was a profit, the corporation would pay the tax and the stockholders could claim refund for the tax paid on their share of the Subchapter S net income, except for income distributions made by the corporation. If the corporation sustained a loss, the shareholders' share of such loss would be disallowed on their returns, and the loss would be available to the corporation for carryover and carryback purposes. It would appear that the corporation would not be subjected to a penalty for failure to file a return if it filed the prescribed information return. Consequently, this penalty for being wrong is not severe unless distributions of profits had been made.

Perhaps a more potent penalty would be that the corporation may not again, without permission of the Commissioner, make an election within a five-year period. The reason for this is that the law permits a corporation to elect under Subchapter S if it meets the definition of a "small business corporation" as defined in Section 1371 (a).

This would be a valid election even though the company has rental income in excess of 20 percent of gross receipts. However, the presence of this rental income would terminate the election under the terms of Section 1372 (e) (5). Therefore, there would be an election and termination within the same year. If the corporation should want to use Subchapter S in a later year it would therefore have to wait five years. This may be important if the real estate corporation should want to use Subchapter S in a year in which the property is sold and the rental income does not equal 20 percent of gross receipts, giving effect to the selling price of the property.

Beware of Possible Disqualification of Section 337 Liquidation

The nonrecognition provisions of Code Section 337 can provide real tax relief where a corporation makes sales or exchanges of property pursuant to a complete liquidation. However, in order for these rules to apply it is necessary that there be a genuine liquidation of the business carried on in corporate form. The Internal Revenue Service takes the position that gains and losses pursuant to a corporate liquidation will not qualify for nonrecognition under Section 337 if stockholders owning more than 50 percent of the liquidating corporation end up owning more than 50 percent of the stock of another corporation to which all or part of the assets of the liquidating corporation are transferred. The Internal Revenue Service bases its position on the grounds that the liquidation is not a genuine *complete* liquidation.

This question was raised by a member of our Society who cited the hypothetical case of a corporation which owns several valuable business properties. The controlling stockholder of the corporation wishes to dispose of some of the property and retain some. In order to avoid double taxation, the stockholder conceives the idea of adopting a plan of liquidation for the corporation, selling certain of the properties to unrelated persons at a gain which is not recognized to the corporation. He then sells the remaining properties, which he desires to retain, to another corporation of which he controls more than 50 percent of the stock. Under these circumstances none of the gains or losses on the sales pursuant to the plan of liquidation would come under Section 337.

In informal discussions, representatives of the Internal Revenue Service have indicated that in the past, favorable rulings have been issued under Section 337 where a *minority* stockholder of the liquidating company owned a majority of the stock in a company to which some of the liquidating company's stock were sold or transferred. However, even this position appears to be under question and may be subject to change.

Because of this, stockholders seeking to liquidate their corporations under Section 337 should be cautioned to avoid sales to other controlled corporations or reincorporations of assets received as a liquidating distribution, because of the danger that the benefits of Section 337 may be denied. Where such sales or reincorporations do occur it would be desirable to seek an advance ruling as to the qualification of the liquidation under Section 337.

Increased Basis for Gift Tax Paid

The 1958 tax law provides that where property was received by gift prior to September 2, 1958, the tax basis of the property is increased by the gift tax paid by the donor, where (1) the adjusted basis did not exceed the fair market value on the date of transfer, and (2) the property had not been dis-

posed of by September 2, 1958. Section 1015(d)(1)(B) and the Committee reports are not completely clear on what constitutes a disposition. The language of the statute refers to the following transactions: "sold, exchanged, or otherwise disposed of." For example, does an exchange of securities, which were acquired by gift, for other securities pursuant to a tax-free exchange, constitute a disposition and prevent an increased basis, or does the term "exchanged" refer only to a taxable transaction?

Based on informal discussions with the Internal Revenue Service in Washington, it appears that a liberal interpretation will be followed, consistent with the regulations on Section 2032 (Alternate Valuation for Estate Tax Purposes) where analogous language is used. Thus, stock acquired in a tax-free transaction, as a stock dividend or stock split with respect to gift stock, may have its basis increased by the pro rata portion of the gift tax paid on the original stock transferred.

In connection with this change in the basis rules it should also be brought out that a review of potential basis adjustments should be made not only for gain or loss purposes but also for depreciation or depletion. The increase in basis for gift tax paid by the donor is considered to be an adjustment as of September 2, 1958, and depreciation or depletion may be increased for any period after that date.

Allocation Problems Created by Property Contributed to Partnership

Very often a partnership is formed with property contributed by the various partners having a basis for tax purposes substantially less than the fair market value of the property at the date of contribution to the partnership. Section 704(c)(2) provides for special allocation of depreciation, depletion, or gain or loss with respect to property contributed to a partnership by a partner if the partnership agreement so provides. For example, suppose a partnership is formed and one partner contributes securities having a fair market value of $100,000 and a tax basis of $75,000. The partnership agreement can provide, and such provision will be followed for tax purposes, that the first $25,000 of taxable gain shall be allocated entirely to the contributing partner, and thereafter gain shall be apportioned in accordance with the regular profit-sharing ratio. Under such an arrangement, if the property is ultimately sold for $120,000, the first $25,000 would be allocated to the contributing partner, and the remaining $20,000 of taxable gain would be allocated to all the partners based on their profit-sharing ratio.

This provision of the Code seems fair and equitable and does not create problems as long as the property is sold for an amount in excess of the value at the date of contribution to the partnership. What happens if, in the above example, the property is sold for $90,000? In such a case the Committee reports and the regulations provide that the $15,000 taxable gain will be allocated to the contributing partner and no loss will be allowed the non-contributing partners. Economically, however, the non-contributing partners have sustained a proportionate part of a $10,000 loss ($100,000 less proceeds of sale of $90,000) since the contributing partner received the $100,000 credit in his capital account which was equal to the value of the property at the date of contribution to the partnership.

It should also be noted that Section 704(c)(2) does not apply to property of an existing partnership which has appreciated in value at the time of admission of a new partner. Thus, a new partner may be forced to report taxable

gain on appreciation in the value of property which occurred prior to his becoming a partner.

These are pitfalls which under the present Code provisions can only be corrected by adjustments of the valuation of property contributed to the partnership by the partners in determining the credit to the partners' capital accounts. To avoid this problem the Internal Revenue Code could be amended to provide that the *net* taxable gain or loss can be distributed to the contributing or non-contributing partners in such a manner which would provide for an equitable allocation from an economic standpoint.

An amendment such as this would be an adoption of the "credit-value theory" which was considered by Congress in the development of the 1954 Code and rejected. It was suggested that the non-contributing partners knew exactly what was happening when the partnership was formed, and undoubtedly recognized the possibility of a later shrinkage in value of contributed property. Presumably, this was a calculated risk and therefore no deductions should be permitted. In lieu thereof, the Code provides that the partnership agreement can be drafted or amended to permit a contributing partner to pick up a greater amount of income under such circumstances. The possibility of shrinkage in value and the resultant tax effects should be explained to the partners prior to the formation of a partnership or admission of a new partner when such a provision is contemplated in the partnership agreement.

Presence of Goodwill Can Be Costly In Section 337 Liquidation

Section 337 of the Code is designed primarily to avoid the double tax upon the sale of corporate assets followed by a liquidation of the corporation. However, where part of the liquidating proceeds distributed to stockholders consists of an operating business a further tax problem may be created.

Consider the case of Corporation *A* which operates two profitable departments, *X* and *Y*. It sells *X* at a substantial profit and elects to liquidate so that the gain on the sale will be reported at the stockholders' level instead of by the corporation. The stockholders will receive as their liquidating proceeds the consideration received for the sale of Department *X* and the assets of Department *Y*, which will henceforth be operated as a partnership.

The shareholders' capital gain will be the excess of the fair market value of the assets received over the basis of the stock. Consequently, the fair market value of Department *Y* must be determined.

It has been established that goodwill is an asset which must be valued in connection with a corporate liquidation where the business will be continued in some other form (*Floyd W. Estes*, 1947, 168 F(2d) 68). The method of valuation used by the government is set forth in A.R.M. 34 (1920; 2 CB 31). Of course, if it can be shown that the earnings are due to the personal talents, services or skills of the stockholders, then goodwill may not exist (*Howard B. Lawton*, 1946, 6 TC 1093.)

If there is goodwill attributable to the earnings of Department *Y*, then upon liquidation of the corporation, the shareholders will be faced with the payment of a capital gains tax upon the fair market value of the goodwill. The basis of this intangible asset so established may not be amortized or deducted against the future operations of the partnership.

In factual situations of this nature, taxpayers must balance the advantages of taking out of the corporation the liquid assets resulting from the sale, against the additional capital gains tax payable.

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